91-570

(1)

No. ____

IN THE

Supreme Court of the United States

October Term, 1991

PMI INDUSTRIES, INC., CONTROL SYSTEMS CORPORATION, WEDGE GROUP, INC. AND SALOMON BROTHERS INC,

Petitioners,

v.

FOLGER ADAM COMPANY,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTIONS PRESENTED

1. Whether Section 12(2) of the Securities Act of 1933 applies only to initial public offerings or distributions of newly-created securities, which is a subject of conflict among the United States Courts of Appeals.

2. Whether the Court of Appeals erred in effectively precluding use of this Court's "alter the total mix" formulation to evaluate the materiality of information under the federal securities laws.

PARTIES TO THE PROCEEDING

The parties to this proceeding are all identified in the caption.*

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* The following information is provided pursuant to this Court's Rule 29.1: petitioner Control Systems Corporation is a subsidiary of petitioner PMI Industries, Inc.; petitioner PMI Industries, Inc. is a subsidiary of petitioner WEDGE Group, Inc.; petitioner WEDGE Group, Inc. is a subsidiary of WEDGE International Holdings, N.V., a privately-held company. Petitioner WEDGE Group, Inc. has one subsidiary not wholly-owned, Process Systems International, Inc. Petitioner Salomon Brothers Inc is a subsidiary of Salomon Brothers Holding Company Inc and Salomon Inc, and is the corporate parent of Salomon Brothers International, Inc.

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Petitioners PMI Industries, Inc. ("PMI"), Control Systems Corporation ("CSC"), WEDGE Group, Inc. ("WEDGE") and Salomon Brothers Inc ("Salomon"), defendants below, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered on July 15, 1991, which reversed a final judgment entered against plaintiff Folger Adam Company ("Folger Adam") by the United States District Court for the Southern District of New York (Knapp, J.). The judgment entered by the District Court followed a seven-week jury trial and verdict in favor of defendants. Folger Adam's claims arose out of its purchase from PMI of the stock of two subsidiaries, Stewart Decatur Security Systems, Inc. ("Stewart") and The William Bayley Company ("Bayley"). Folger Adam alleged violations of Section 12(2) of the Securities Act of 1933 (the "Securities Act"), 15 U.S.C. § 77l(2), Section 10(b) of the

Securities Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, and the common law. The jury found that no material misrepresentation or omission was made in connection with the sale of the stock of Stewart and Bayley. The Court of Appeals faulted the District Court for instructing the jury that information is material if it would significantly alter the "total mix" of information made available, without also explicitly stating that material information need not change the reasonable investor's decision. The Court reversed the judgment because that instruction "may have" confused the jury.

Because the case was remanded by the Court of Appeals for a new trial, petitioners also respectfully pray that a writ of certiorari issue to review the ruling of the United States District Court for the Southern District of New York, entered on March 29, 1990, which permitted plaintiff to pursue its claim under Section 12(2) of the Securities Act despite the fact that plaintiff did not purchase the stock in an initial public offering but, instead, purchased the stock post-issuance in the "secondary" market in a privately-negotiated transaction after months of face-to-face due diligence.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Second Circuit is reported at 938 F.2d 1529, and is reproduced at Appendix A hereto. The opinion of the United States District Court for the Southern District of New York denying, *inter alia*, defendants' motion for summary judgment on plaintiff's Section 12(2) claim is unreported, and is reproduced at Appendix B hereto.

JURISDICTION

The judgment of the Court of Appeals for the Second Circuit was entered on July 15, 1991. A copy of the judgment is reproduced at Appendix C hereto. Defendants petitioned the Court of Appeals for Rehearing with a Suggestion for Rehearing In Banc. That petition and

suggestion was denied on August 29, 1991. A copy of the order denying rehearing is reproduced at Appendix D hereto. By order dated September 11, 1991, the Court of Appeals granted petitioners' motion to stay the issuance of the mandate for 30 days, pending the filing of this petition for a writ of certiorari. Federal jurisdiction is invoked pursuant to 28 U.S.C. § 1331 (1988), and the jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1) (1988).

STATUTES AND REGULATION INVOLVED

Section 12(2) of the 1933 Securities Act, 15 U.S.C. § 77l(2) (1981), provides that:

Any person who—

* * *

> (2) offers or sells a security (whether or not exempted by the provisions of § 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 10(b) of the 1933 Securities Act, 15 U.S.C. § 78j(b) (1981), provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1986), provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

This case arose out of the purchase by plaintiff Folger Adam, a leading manufacturer of detention industry equipment, of Stewart and

Bayley, companies in the same industry. The previously-issued and outstanding stock of Stewart and Bayley was purchased from defendant PMI,[1] which retained the investment bank of Salomon to assist in the sale.

After the leveraged buy-out firm of Adler & Shaykin, which controlled Folger Adam, approached PMI about acquiring Stewart and Bayley, it was furnished with a sales memorandum. Adler & Shaykin then indicated that it wanted to make a preemptive bid. The parties therefore signed a Letter of Intent, subject to due diligence. Folger Adam and Adler & Shaykin wanted the right to conduct due diligence so that they could "ma[k]e our own assessment" of what Stewart and Bayley were worth.

After the Letter of Intent was signed, Adler & Shaykin and Folger Adam started an "intense" due diligence effort which lasted five months. Folger Adam, Adler & Shaykin and their consultants had free access to Stewart and Bayley's records and employees, including the managers whose views of the companies, Folger Adam contended, were critical to the decision to proceed with the acquisition. During the due diligence process, Folger Adam amassed volumes of information about the companies, some of it favorable and some of if unfavorable. With the information obtained during its due diligence, Folger Adam evaluated the projections it had been furnished for Stewart and Bayley and concluded they were "reasonable." Folger Adam also prepared its own sales and operating income projections for the companies that extended further out into the future than—and were higher than—the projections it had been given.

The issue presented to the jury, dispositive of plaintiff's Section 12(2), Section 10(b) and common law fraud claims, was whether either (a) the projections furnished to Folger Adam were materially misleading, or (b) omitted and admittedly hastily-drawn projections by managers of Stewart and Bayley who had a history of "serv[ing] up numbers that were too easy to hit" and who were interested in purchas-

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1 WEDGE is the parent company of PMI. PMI owned Stewart and Bayley through defendant CSC, a wholly-owned subsidiary and holding corporation.

ing the companies themselves, were material. After hearing seven weeks of evidence concerning the nature of the projections given and omitted and the wealth of information uncovered by Folger Adam in the due diligence process, the jury responded in the negative. The jury answered special interrogatories, finding no material misrepresentation or omission, and returned a verdict for defendants. On appeal, the Court of Appeals reversed the judgment based upon its finding of an erroneous instruction to the jury regarding the meaning of the materiality requirement of the federal securities laws.

REASONS FOR GRANTING THE WRIT

I. THIS COURT SHOULD GRANT CERTIORARI TO RESOLVE THE CONFLICT AMONG CIRCUIT AND DISTRICT COURTS OVER WHETHER CONGRESS INTENDED SECTION 12(2) OF THE SECURITIES ACT TO APPLY TO SALES OF SECURITIES BEYOND INITIAL PUBLIC OFFERINGS

The issue of whether, in enacting Section 12(2) of the Securities Act governing initial public offerings of securities, Congress intended to also regulate post-distribution or "secondary" market[2] sales of securities, has consumed numerous opinions over the last several years alone. Most district courts which have considered the issue recently have held that Section 12(2), and the Securities Act in general, do not apply to such sales.[3] Some district courts, however—even within the

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[2] "Secondary" markets are defined as the means by which owners of previously-issued and outstanding securities are provided liquidity in the resale of such securities. *See generally* R. Jennings, H. Marsh, *Securities Regulation* 1657 (6th ed. 1987); M. Stigum, *Money Market Calculations: Yields, Break-Evens, and Arbitrage* 191 (1981).

[3] *See Bank of Denver* v. *Southeastern Capital Group, Inc.*, 763 F. Supp. 1552, 1559 (D. Colo. 1991); *T. Rowe Price New Horizons Fund, Inc.* v. *Preletz*, 749 F. Supp. 705, 707-09 (D. Md. 1990); *Cox* v. *Eichler*, 765 F. Supp. 601, 609 (N.D. Cal. 1990); *Grinsell* v. *Kidder, Peabody & Co.*, 744 F. Supp. 931, 932-34 (N.D. Cal. 1990); *Leonard* v. *Stuart-James Co.*, 742 F. Supp. 653, 658 (N.D. Ga. 1990);

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same districts as those courts properly limiting the scope of Section 12(2) to initial offerings—have taken the opposite view.[4]

More importantly, there is a conflict between two Circuit Courts of Appeals on the matter. The Court of Appeals for the Third Circuit recently resolved the question against an expanded reading of Section 12(2)'s intended scope in *Ballay* v. *Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir. 1991), petition for certiorari filed June 19, 1991, No. 90-1924. In *Ballay*, the court reversed a jury verdict awarding investors damages under Section 12(2), finding that the Section provides a remedy to purchasers only in the context of initial distributions.

The *Ballay* decision is in direct conflict with a recent decision of the Court of Appeals for the Seventh Circuit, *Short* v. *Belleville Shoe*

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Mix v. *E.F. Hutton & Co.*, 720 F. Supp. 8, 10-12 (D. D.C. 1989); *First Union Brokerage* v. *Milos*, 717 F. Supp. 1519, 1522-23 (S.D. Fla. 1989); *McCowan* v. *Dean Witter Reynolds, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,423 at 92,726-27 (S.D.N.Y. April 11, 1989); *Cheltenham Bank* v. *Drexel Burnham Lambert, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,391 at 92,542 (E.D.N.C. March 15, 1989); *Panek* v. *Bogucz*, 718 F. Supp. 1228, 1232-33 (D.N.J. 1989); *Strong* v. *Paine Webber, Inc.*, 700 F. Supp. 4, 5 (S.D.N.Y. 1988); *Ralph* v. *Prudential-Bache Securities, Inc.*, 692 F. Supp. 1322, 1323-24 (S.D. Fla. 1988); *SSH Co.* v. *Shearson Lehman Bros. Inc.*, 678 F. Supp. 1055, 1059 (S.D.N.Y. 1987); *Ackerman* v. *Clinical Data, Inc.*, [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,207 at 91,568 (S.D.N.Y. July 8, 1985); *Klein* v. *Computer Devices, Inc.*, 591 F. Supp. 270, 272-78 (S.D.N.Y. 1984), *modified*, 602 F. Supp. 837 (S.D.N.Y. 1985); *Gross* v. *Diversified Mortg. Investors*, 431 F. Supp. 1080, 1095 (S.D.N.Y. 1977), *aff'd*, 636 F.2d 1201 (2d Cir. 1980).

[4] *See In Re Ramtek Secur. Litig.*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. ¶ 95,814 at 98,912-13 (N.D. Cal. Feb. 4, 1991); *In Re Consolidated Capital Secur. Litig.*, [1990 Transfer Binder] Fed. Sec. L. Rep. ¶ 95,238 at 96,056 (N.D. Cal. Feb. 26, 1990); *Farley* v. *Baird, Patrick & Co.*, 750 F. Supp. 1209, 1219-21 (S.D.N.Y. 1990); *Elysian Federal Sav. Bank* v. *First Interregional Equity Corp.*, 713 F. Supp. 737, 747-51 (D. N.J. 1989); *Hoxworth* v. *Blinder, Robinson & Co.*, No. 88-0285, 0286, 0307 (E.D. Pa. May 23, 1989) (LEXIS, Genfed library, Dist file) *vacated on other grounds*, 903 F.2d 186, 203-04 (3d Cir. 1990); *Scotch* v. *Moseley, Hallgarten, Estabrook & Weeden, Inc.*, 709 F. Supp. 95, 97-98 (M.D. Pa. 1988).

Mfg. Co., 908 F.2d 1385, 1390 (7th Cir. 1990) ("Section 12(2) addresses all other forms of materially incorrect or misleading selling literature and oral communications in the sale of a security" not covered by Sections 11 or 12(1) and, thus, is not limited to initial offerings), *cert. denied*, ___U.S. ___, 111 S. Ct. 2887 (1991). Although the conflicting interpretation of Section 12(2)'s scope in *Short* was *dicta*, the interpretation has nonetheless been viewed as precedent supporting a broad application of Section 12(2) to post-distribution transactions. *See Farley* v. *Baird, Patrick & Co.*, 750 F. Supp. 1209, 1220-21 (S.D.N.Y. 1990). *See also* Maynard, "Liability Under Section 12(2) of the Securities Act of 1933 For Fraudulent Trading in Postdistribution Markets," 32 Wm. & Mary L. Rev. 847, 847 n.6 (1991).

This case squarely presents the issue of whether one who (a) purchased securities in a secondary market, (b) clearly has a private federal cause of action for alleged securities fraud under Section 10(b) of the Exchange Act, and (c) acted only after months of "face-to-face" due diligence, may also maintain a private cause of action under Section 12(2), a "strict liability" provision. This Court should grant certiorari and decide this important question, resolving the conflicting application of the securities laws.[5]

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[5] The issue of the scope of Section 12(2) was raised and briefed by petitioners in their motion for summary judgment to the District Court. Although it was not addressed by the parties on respondent's appeal (which dealt primarily with the correctness of the trial court's jury charge on the question of "materiality"), this Court's power to grant a writ of certiorari extends to issues that were decided in the district court but not raised in the court of appeals. *Wood* v. *Georgia*, 450 U.S. 261, 265 n.5 (1981). Indeed, this Court has jurisdiction to grant certiorari to consider issues not raised in any lower court. *Carlson* v. *Green*, 446 U.S. 14, 17 n.2 (1980); *Youakim* v. *Miller*, 425 U.S. 231, 234 (1976). The Court has exercised its power to decide issues not addressed by the court of appeals particularly in cases where, as here, the issue presents a pure question of law, is important and is likely to recur. *See Mitchell* v. *Forsyth*, 472 U.S. 511, 530 (1985); *Nixon* v. *Fitzgerald*, 457 U.S. 731, 743 and n.23 (1982); *cf. City of Newport* v. *Fact Concerts, Inc.*, 453 U.S. 247, 257 (1981).

A. The Plain Language Of Section 12(2)—"Prospectus Or Oral Communication"—Clearly Limits The Scope Of Section 12(2) To Initial Distributions Of Securities

Section 12(2) provides for the liability of any person who "offers or sells a security . . . by means of a prospectus or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . ." 15 U.S.C. § 77l(2). The meaning of the phrase "prospectus or oral communication" is critical to a determination of the reach of Section 12(2), and should be construed on the basis of the language's context, ordinary usage and compatibility with the surrounding law. *See Green* v. *Bock Laundry Machine Co.*, 490 U.S. 504, 528 (1989) (Scalia, J. concurring). Thus, as the Court of Appeals for the Third Circuit held in *Ballay*:

> We believe that Congress employed the term "prospectus" as a term of art which describes the transmittal of information concerning the sale of a security in an initial distribution.
>
> * * *
>
> If it had intended an expansive meaning for the term "prospectus," Congress more simply could have drafted Section 12(2) to describe all "written or oral communications."

925 F.2d at 688-89.[6] *See also Mix* v. *E.F. Hutton & Co.*, 720 F. Supp. at 11 ("the term 'prospectus' obviously appears to refer to initial distribution"); *Servco, Inc.* v. *Emich Oldsmobile, Inc.*, No. 5:89-CV-110

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[6] The *Ballay* decision's well-considered discussion of the meaning of "prospectus" is helpful:

> In addition to its definition, the use of the term "prospectus" in various sections of the 1933 Act supports a reading restricted to initial distributions. Section 10 of the 1933 Act, 15 U.S.C. § 77j, which mandates the information required in a prospectus, clearly ties a prospectus with registration statements filed with the Securities Exchange Commission. For example, a prospectus shall contain the information required in a registration statement, but may

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(W.D. Mich. Nov. 19, 1990) (LEXIS, Genfed library, Dist File) (same).

The words "oral communication" are not defined in the Securities Act and thus must be interpreted "in light of their context in the statute and in keeping with the intent of Congress in passing the 1933 Act." *Ballay*, 925 F.2d at 688, citing *K Mart Corp.* v. *Cartier, Inc.*, 486 U.S. 281, 291 (1988) ("if the statute is clear and unambiguous, that is the end of the matter, for the court . . . must give effect to the unambiguously expressed intent of Congress"). *Ballay* and other decisions have treated the words "prospectus or oral communication" as "related terms," which must be construed together. *See Ballay*, 925 F.2d at 688 ("[t]he maxim *noscitur a sociis*, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress"), quoting *Jarecki* v. *G.D. Searle & Co.*, 367 U.S. 303, 307 (1961); *see also Grinsell* v. *Kidder*,

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omit some documents required of registration statements. 15 U.S.C. § 77j(a)(1). Section 10(a)(3) pro-vides for current information in a prospectus used over nine months from the effective date of the registration statement. 15 U.S.C. § 77j(a)(3). Even an abbreviated prospectus authorized by section 10(b), 15 U.S.C. § 77j(b), which is not subject to the registration statement requirements of section 11, 15 U.S.C. § 77k, must be filed with the registration statement. Further, under section 5(b)(1), 15 U.S.C. § 77e(b)(1), a prospectus not meeting the requirements of section 10 may not be used in interstate commerce to sell registered securities. In addition, in its award of special powers to the Securities Exchange Commission, Congress gave the Commission power to amend requirements for "registration requirements and prospectuses." 15 U.S.C. § 77s. Thus Congress repeatedly used the term "prospectus" in provisions concerning registration statement requirements in initial distributions.

As well, the exemptions Congress provided to the definition of "prospectus" in section 2(10) are consistent with the overall policy to ensure full disclosure to purchasers in batch offerings. These provisions permit offerors of securities to provide additional information to potential investors that is not subject to the requirements of section 10 where these communications either merely add to information previously provided the investor in the form of a section 10 prospectus, or clearly "state[] from whom a written prospectus meeting the requirements of [section 10] may be obtained."

925 F.2d at 688-89 (footnote omitted).

Peabody & Co., 744 F. Supp. at 934; *Panek* v. *Bogucz*, 718 F. Supp. at 1232; *First Union Brokerage* v. *Milos*, 717 F. Supp. at 1522; *Ralph* v. *Prudential-Bache Securities, Inc.*, 692 F. Supp. at 1324; *SSH Co.* v. *Shearson Lehman Bros. Inc.*, 678 F. Supp. at 1059.

Indeed, a broader interpretation of "oral communications" to include statements made in connection with secondary sales and trading in addition to initial public offerings would create an anomaly whereby "secondary" sellers "would be liable only for oral and not written misrepresentations because the term 'prospectus' is limited to initial offerings . . . . This distinction makes no logical sense." *Ballay*, 925 F.2d at 689; *see also Grinsell*, 744 F. Supp. at 934 ("This Court can find no logical reason in policy or equity for assuming such an odd departure from the Act's focus on new offerings"). Thus, as numerous courts have held, Congress' limitation of Section 12(2) to misstatements or omissions made in a "prospectus or oral communication," on its face, limits that provision to initial distributions of securities.

B. The Legislative History Of The Securities Act And Section 12(2) Supports An Interpretation Limiting The Scope Of The Section To Initial Distributions

Because the text of a statute is the best evidence of its purpose and the phrase "prospectus or oral communication" is unambiguous, there should be no need to resort to Section 12(2)'s legislative history to determine its scope. *See West Virginia University Hospitals, Inc.* v. *Casey*, __U.S.__, 111 S. Ct. 1138, 1147 (1991). If this Court finds ambiguity in the statute's text, however, it would be appropriate to examine the legislative history of the particular provision, as well of the statute as a whole, to ensure that judicial interpretation effectuates, and does not conflict with, underlying congressional intent. *Aaron* v. *Securities and Exchange Comm'n*, 446 U.S. 680, 697-700 (1980); *United States* v. *Naftalin*, 441 U.S. 768, 774-77 (1979); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 206-11 (1976).

The plain meaning of the phrase "prospectus or oral communication" is amply supported by the legislative history of the Securities Act and Section 12(2). The Third Circuit in *Ballay*, as well as district

courts addressing this issue, have found "[n]othing in the legislative history or structure of the 1933 Act [that would] indicate[] that Congress intended to broaden section 12(2) beyond the Act's principal purpose of regulating the distribution of new offerings." 925 F.2d at 690; *see also Grinsell* v. *Kidder, Peabody & Co.*, 744 F. Supp. at 933-34; *Cox* v. *Eichler*, 765 F. Supp. at 609; *T. Rowe Price New Horizons Fund, Inc.* v. *Preletz*, 749 F. Supp. at 708-09; *Mix* v. *E.F. Hutton & Co.*, 720 F. Supp. at 11; *Panek* v. *Bogucz*, 718 F. Supp. at 1232.

A House of Representatives committee report states that the 1933 Securities Act was meant to "affect[] only new offerings of securities . . . ." H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933); *accord* L. Loss, *Fundamentals of Securities Regulation* 87 (2d ed. 1988) ("The 1933 Act is concerned primarily with *distributions*. Post-distribution trading was to be the subject of further legislation, which turned out to be the 1934 Act") (emphasis in original). As the court in *Mix* v. *E.F. Hutton & Co.* noted:

> Most significantly, on the civil liabilities created by Section 11 and 12, the "committee emphasize[d] that these liabilities attach only where there has been an untrue statement of material fact or an omission to state a material fact in the registration statement or the prospectus—the basic information by which the *public* is solicited."

720 F. Supp. at 11, quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933) (emphasis added).

This interpretation of Section 12(2) is also consistent with the legislative history of the criminal prohibitions of Section 17(a) of the Securities Act, 15 U.S.C. § 77q (a) (1988), and this Court's interpretation of that section. In *United States* v. *Naftalin*, this Court held that:

> [a]lthough it is true that *the 1933 Act was primarily concerned with the regulation of new offerings* . . . the antifraud prohibition of *§ 17(a) was meant as a major departure from that limitation. Unlike much of the rest of the Act*, it was intended to cover any fraudulent scheme in an offer or sale of securities, whether in

> the course of an initial distribution or in the course of ordinary market trading.

441 U.S. at 777-78 (emphasis added). In making the determination that Section 17(a) applied to secondary sales as well as initial distributions, the Court in *Naftalin* relied in part upon the accompanying Senate Report which states:

> The [Securities] act subjects the sale of old or outstanding securities to the same *criminal* penalties and injunctive authority for fraud, deception, or misrepresentations as in the case of new issues.

S.R. Rep. No. 47, 73d Cong., 1st Sess. 4 (1933) (emphasis added). "In contrast, there is no corresponding statement conferring such a broad scope on the civil liabilities of Section 12 anywhere in the legislative history." *Mix* v. *E.F. Hutton & Co., Inc.*, 720 F. Supp. at 12; *see also Grinsell* v. *Kidder, Peabody & Co.*, 744 F. Supp. at 933.

Of course, an interpretation of Section 12(2) consistent with its legislative history will not deprive stock purchasers of a federal remedy if they are defrauded. Instead, "[r]emedies available to . . . secondary market purchasers who allege misstatements or omissions are contained in the antifraud provisions of the Securities Exchange Act of 1934, not in Section 12(2) . . . ." *Cheltenham Bank* v. *Drexel Burnham Lambert Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,391 at 92,542. However, if a broad interpretation is forced onto Section 12(2), it is inevitable that "the more lenient requirements of section 12(2) would effectively eliminate the use of section 10(b) by securities purchasers," since that section of the 1934 Exchange Act includes elements of scienter, reliance and causation, in addition to materiality. *Ballay*, 925 F.2d at 689, 692.

C. The Limitation Of Section 12(2) To The Public Offering Of New Securities Is Not In Conflict With This Court's Rejection Of The "Sale Of Business" Doctrine

In this case, the transaction was structured as a purchase of Stewart and Bayley's issued and outstanding securities. The sale was not

accomplished in an initial distribution.[7] Defendants argued below that plaintiff should therefore be relegated to pursuing a remedy under Section 10(b) of the Exchange Act. Upon motions for summary judgment the District Court rejected petitioner's argument on the scope of Section 12(2), however, because the transaction constituted a sale of a business rather than the sale of individual shares of a corporation. The court held:

> the Supreme Court five years ago decisively rejected a narrow interpretation of Congressional intent and, without making any distinction between "newly created" securities and those existing prior to sale, declared that section 12(2) applies to the private sale of a company's stock.

Folger Adam Company v. *PMI Industries, Inc.*, No. 87 Civ. 9272 (WK) (S.D.N.Y. March 29, 1990) (LEXIS, Genfed library, Dist file) (Appendix B at 18a), citing *Gould* v. *Ruefenacht*, 471 U.S. 701 (1985); *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681, 694-97 (1985).

Petitioners, however, are not making any attempt to resurrect the "sale of business" doctrine. Nor are they challenging this Court's decisions in *Landreth* and *Gould*, which did not address whether Section 12(2) applies outside the context of initial distribution of securities. Those decisions stated that the issue before the Court was whether the sale of all or 50% of the stock of a company "is a securities transaction subject to the *antifraud* provisions of the federal securities laws." *Landreth Timber*, 471 U.S. at 683 (emphasis added); *Gould*, 471 U.S. at 702 (emphasis added). Both cases simply found that courts were not required to perform an "economic realities" test or to determine whether "control has passed to the purchaser" in finding that a transaction involved a sale of "securities" under either the Securities Act or

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[7] In the securities law context, courts have construed the word "distribution" as synonymous with the term "public offering." *See, e.g., Cheltenham Bank*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,391 at 92,541; *Gilligan, Will & Co.* v. *Securities and Exchange Comm'n*, 267 F.2d 461, 466 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959); *see also* "The Section '4(1½)' Phenomenon: Private Resales of Restricted Securities," 34 Bus. Law. 1961, 1966-67 (1979).

the Exchange Act. *Landreth Timber*, 471 U.S. at 688-92, 695-97; *Gould*, 471 U.S. at 704-06.

Regardless of whether all or some of a corporation's stock is sold, Section 12(2) properly applies only to the distribution of newly-created securities. By extension, Section 12(2) does not apply to face-to-face transactions in which the purchaser has the opportunity to conduct due diligence and the protections applicable to initial offerings made pursuant to a prospectus are unnecessary. Because the Court of Appeals remanded this case, petitioners respectfully submit that a writ of certiorari should be granted to avoid a needless retrial of respondent's Section 12(2) claim and to decide an important federal securities law question in which the courts are in conflict. Indeed, this case offers the Court the opportunity to rule on both whether Section 12(2) should be limited to initial distributions, the issue also raised by the pending petition for certiorari in *Ballay* v. *Legg Mason Wood Walker, Inc.*, and whether Section 12(2) applies to privately-negotiated, face-to-face securities transactions where the purchaser has the ability to conduct its own due diligence and need not rely solely on information which the seller elects to include in a prospectus.

II. THE COURT OF APPEALS HAS INCORRECTLY APPLIED AND SIGNIFICANTLY CHANGED THE STANDARD FOR "MATERIALITY" UNDER THE FEDERAL SECURITIES LAWS BY MISCONSTRUING THIS COURT'S "TOTAL MIX" TEST

A. This Court Should Summarily Reverse The Clear Error By The Court Of Appeals

1. The Court of Appeals' Ruling is Manifestly Erroneous

This action arose out of a negotiated private transaction following months of due diligence by plaintiff, and the materiality of any alleged misstatement or omission could only be assessed in that context. Accordingly, the District Court's charge utilized the most appropriate

of the four alternative formulations of the materiality test set forth in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976), *i.e.*, "alter the 'total mix' of information made available." The District Court charged the jury that:

> In the context of this case a fact is material when there is a substantial likelihood that, if a reasonable investor had learned of the falsity of the misstatement of fact or the existence of the omitted fact, that investor would have regarded the total mix of information available to have been significantly altered.[8]

The Court of Appeals reversed the judgment after a seven-week trial because that charge "may have" confused the jury. The Court ruled that the "total mix" test for materiality is inappropriate, without further explanation, because it is "outcome-determinative":

> we think that the jury would take the "total mix" formulation to mean that a material fact is one that would cause a reasonable investor to change her decision on whether to consummate a transaction.

Appendix A at 7a.

The Court of Appeals' rejection of the "total mix" test is in direct conflict with this Court's established precedent. In *TSC* v. *Northway*, this Court, recognizing that the general policy of full disclosure is certainly not without limit, defined materiality as follows:

> An omitted fact is material if there is a *substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.* This standard is fully consistent with *Mills' [v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970)] general description of materiality as a requirement that, "the defect have a significant *propensity* to affect the voting process." It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a show-

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[8] The complete text of the charge on materiality is set forth in Appendix A at 5a n.2.

> ing of a substantial likelihood that, *under all the circumstances*, the omitted fact *would have assumed actual significance in the deliberations of the reasonable shareholder*. Put another way, *there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available*.

438 U.S. at 449 (emphasis added) (footnote omitted). The *TSC* definition thus embodies the notion that a fact may bear significance only in relation to the circumstances surrounding it—*i.e.*, to the "total mix" of information available. After *TSC*, its "total mix" formulation quickly became embedded in the very fabric of the federal securities laws.[9] Most recently, in *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), this Court explicitly reaffirmed the "total mix" portion of *TSC*'s definition:

> [*TSC* v. *Northway*] further explained that to fulfill the materiality requirement "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." [*TSC* v. *Northway*] at 449. We now expressly adopt the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context.

Id. at 231-32 (footnote omitted). Because the charge was based directly on this Court's authority, the Court of Appeals' reversal was necessarily wrong.

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[9] Indeed, countless decisions have *turned precisely* on the "total mix" portion of the *TSC* definition of materiality. *See, e.g., Mendell* v. *Greenberg*, 927 F.2d 667, 673-75 (2d Cir. 1990), *modified on other grounds*, 938 F.2d 1528 (2d Cir. 1991); *Kademian* v. *Ladish Co.*, 792 F.2d 614, 624 (7th Cir. 1986); *Malone* v. *Safety-Guard Mfg. Co.*, 748 F.2d 312, 315 (5th Cir. 1984); *In re Smith*, 737 F.2d 1549, 1555 (11th Cir. 1984); *Securities and Exchange Comm'n* v. *American Board of Trade, Inc.*, 751 F.2d 529, 540 (2d Cir. 1984) (Friendly, J.); *United States* v. *Marcus Schloss & Co.*, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,840 at 94,560 (S.D.N.Y. Dec. 6, 1989) ("A powerful argument can be made that such information is material standing alone. But it does not stand alone. [*TSC* v.] *Northway* instructs us to look to the 'total mix' of available information").

In addition, we respectfully submit that the Court of Appeals' understanding of the "total mix" test is simply incorrect. *TSC's* "significantly alter the 'total mix' of information made available" test suggests a change in vote no more than *TSC's* "important enough to assume actual significance in the deliberations of the reasonable shareholder" test, the use of which the Court of Appeals instructed on remand. Appendix A at 10a. Petitioners are not aware of a single instance in which any other court has rejected the "total mix" language because it "may" be construed as outcome-determinative, held that an instruction based on it is erroneous unless embellished, or suggested that it is different from any of the alternative formulations of the materiality definition in *TSC* v. *Northway.*

Indeed, it is ironic that the Court of Appeals should suggest that the "total mix" formulation is in need of explanation, when that is precisely what the District Court did—only to incur condemnation. In an effort to explain the "total mix" concept to the jury, the District Court charged that "significantly altering the total mix of information available" means that the omitted information "would have caused [the reasonable investor] to *alter its views as to the desirability of proceeding* with the purchase." Appendix A at 5a n.2. (emphasis added). The Court ruled that this paraphrase "may have" led the jury to believe it was required to find that the investor actually *changed its mind* because of the alleged misstatement. This ruling is incorrect on its face. The word "alter" modified "desirability," and "changing the desirability" does not mean "changing the decision." "[A]lter[ing one's] views as to the desirability of proceeding," as the District Court instructed, is simply not the equivalent of "changing one's mind about whether to proceed." The desirability of proceeding may be increased so as to confirm a decision to proceed, or it may be decreased, but not so much as to cause a change in plans.[10]

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[10] The District Court's use of the "alter . . . the desirability" language and construction is an accurate and helpful characterization of the "total mix" test in practice, for under the *TSC/Basic* test, a "material" fact would *necessarily* alter, at least to some degree, one's view as to the desirability of proceeding with the transaction.

Footnote continued on next page

2. This Court Should Reestablish the "Total Mix" Formulation by Summary Reversal

Although the Court of Appeals professed to retain the "total mix" formulation, Appendix A at 7a n.4, it is clear that it has done nothing less than eviscerate it. In fact, the Court (a) reversed a seven-week trial that concluded with a charge that set forth a verbatim statement of this Court's "total mix" formulation, and (b) remanded with explicit instructions to use the "assume actual significance" formulation. In the wake of such a result, district judges and litigants will utilize the "total mix" test—embellished or not—only at their peril.

Without a reversal of its unusual ruling, the Court of Appeals for the Second Circuit's significant voice on matters pertaining to federal securities laws,[11] will operate swiftly to obliterate this Court's "total mix" formulation. Indeed, already the Court of Appeals' opinion in *Folger Adam* v. *PMI* has been cited as support for a definition of materiality that is completely devoid of any mention of the "total mix" formulation. In *Katz* v. *Pels*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,125 at 90,698 n.4 (S.D.N.Y. July 22, 1991), the Court held "[an] omitted or misrepresented fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote, or if the fact would have assumed actual significance in a reasonable investor's decision on whether to consummate the transaction," citing *Folger Adam Company* v. *PMI Industries, Inc.*, No. 90 Civ. 7798 (2d Cir. July 15, 1991).

Footnote continued from previous page

It is difficult to imagine how a fact could be "consider[ed] important in deciding how to vote," "have a significant propensity to affect the voting process," "assume[] actual significance in the deliberations of the reasonable shareholder," or be substantially likely to be "viewed by the reasonable investor as having significantly altered the 'total mix' of information available" (the four alternative materiality formulations found in *TSC* v. *Northway*), and not also "cause[] [the reasonable investor] to alter its view as to the desirability of proceeding with the purchase."

[11] Courts throughout the United States follow the Second Circuit in securities cases—even when they disagree with it—because of its "preeminence in the field of securities law." *Zoelsch* v. *Arthur Andersen & Co.*, 824 F.2d 27, 32 (D.C. Cir. 1987).

The reversal of the jury verdict after a very lengthy trial based on such fine semantic distinctions is particularly disturbing in light of the tremendous burden district courts now face.[12] Here, the District Court instructed the jury in the exact language prescribed by this Court, and the Court of Appeals reversed because it considered the instruction *potentially* confusing. Petitioners submit that district courts already laboring under Herculean burdens cannot withstand the additional strain of retrying mammoth cases based upon semantic distinctions that, in all likelihood, will be lost on the jury in any event.[13] A trial court system so burdened requires an appellate court with a preference for resolution rather than perpetuation, yet the Court below has suddenly indulged its unique views on materiality and abandoned any effort to strike a realistic balance between metaphysical perfection in trial transcripts and absolute chaos in trial courts. We respectfully suggest that this Court's power to summarily reverse, by its Rule 16.1 and 28 U.S.C. § 2106 (1988), could not be more appropriately exercised than under the circumstances here.

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[12] In 1990, a total of 30,653 cases were pending in the district courts within the Second Circuit—13,529 in the Southern District of New York alone. *Report of the Circuit Executive, United State Court of Appeals for the Second Circuit*, 1991, at 13, 28. These figures represent a 54% and 51% increase, respectively, over such statistics for 1980. *Report of the Circuit Executive, United State Court of Appeals for the Second Circuit*, 1981 at 11, 37. Chief Justice Rehnquist, among others, repeatedly has warned of the severity of the problem of district court backlog:

> In short, the federal court system is like a city in the arid part of this country which is using every bit of its water system to supply current needs. We must think not of building new subdivisions, but of conserving water. More accurately, we must think of conserving water and cutting down on some present uses of water because we know that some new subdivisions will inevitably be built.

Remarks of the Chief Justice, the American Bar Association, Mid-Year Meeting, Denver, Colorado, February 6, 1989.

[13] It is especially unfortunate that the Court of Appeals ignored its own well-established rules governing "harmless error." *United States* v. *Torres*, 845 F.2d 1165 1171 (2d Cir. 1988); *United States* v. *Ouimette*, 798 F.2d 47, 49 (2d Cir. 1986), *cert. denied*, 488 U.S. 863 (1988); *cf.* Fed. R. Civ. Pro. 61.

B. This Court Should Grant Certiorari To Clarify The Formulations In *TSC* v. *Northway*

The clear preference by the Second Circuit for one of the four *TSC* formulations ("total mix," "assume actual significance," "consider important in deciding how to vote" and "have significant propensity to affect the voting process") over another suggests that after fifteen years the *relative* value and utility among the *TSC*'s formulations—if indeed any relative differences exist at all—must finally be elaborated upon by this Court. Clearly, inappropriate formulations of the materiality test now have been, and will increasingly be, forced upon district judges and litigants who will be prohibited from fashioning charges to the unique facts of each case.

Petitioners submit that the facts of this case would provide an especially opportune vehicle for making clear delineations among the various *TSC* formulations. The transaction here at issue followed five months of due diligence by the plaintiff in which it amassed an amount of information about Stewart and Bayley—much of it far more unfavorable than the omitted projections—so vast that the materiality of no one piece of information could be considered in isolation, rendering the "total mix" standard the most appropriate. Accordingly, we respectfully request that, in the absence of summary reversal, this Court issue the writ of certiorari and entertain this action.

CONCLUSION

For the foregoing reasons, the requested writ of certiorari should issue.

Dated: October 7, 1991

Respectfully submitted,

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APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
For The Second Circuit

No. 1083 - August Term, 1990
(Argued February 27, 1991 Decided July 15, 1991)
Docket No. 90-7798

FOLGER ADAM COMPANY,
Plaintiff-Appellant,
- v. -

PMI INDUSTRIES, INC., CONTROL SYSTEMS CORPORATION, WEDGE GROUP, INC., AND SALOMON BROTHERS INC.,
Defendants-Appellees.

Before:

Oakes, Chief Judge,
Cardamone and Mahoney, Circuit Judges.

Appeal from a judgment of the United States District Court for the Southern District of New York, Whitman Knapp, *Judge*, dismissing appellant's federal and state securities laws claims. Reversed and remanded, based on an erroneous jury charge regarding the meaning of the materiality requirement of the federal securities laws.

STEVEN B. FEIRSON, New York, NY (George G. O'Brien, Judy L. Popper, Marshall J. Walthew, Michael F.R. Harris, Robert Cohen, Howard S. Schrader, Dechert Price & Rhoads, of counsel), for Plaintiff-Appellant.

MELVYN L. CANTOR, New York, NY (Mary Elizabeth McGarry, John R. Menz, Daniel J. Sullivan, Nicholas Even, Simpson Thacher & Bartlett, of counsel), for Defendants-Appellees PMI Industries, Inc., Control Systems Corporation and WEDGE Group, Inc.

ROBERT B. MAZUR, New York, NY (Warren R. Stern, David Gruenstein, George T. Conway III, Wachtell, Lipton, Rosen & Katz, of counsel), for Defendant-Appellee Solomon Brothers Inc.

OAKES, Chief Judge:

Folger Adam Company ("Folger Adam") appeals from a judgment following a jury trial of the United States District Court for the Southern District of New York, Whitman Knapp, Judge, dismissing its claims under federal and state securities laws against PMI Industries, Inc., WEDGE Group, Inc., Control Systems Corporation (collectively "PMI") and Salomon Brothers Inc. ("Salomon"). Because we find that the district court erroneously instructed the jury regarding the meaning of the materiality requirement of the federal securities laws, and that a properly instructed jury could find that appellees committed omissions or misstatements of material fact in violation of those laws, we reverse and remand for a new trial.

BACKGROUND

In early 1986, PMI, a diversified holding company, began negotiating to sell Stewart Decatur Security Systems and the William Bayley Company (collectively "Stewart/Bayley"), two of its subsidiaries that manufacture detention and security equipment, to Folger Adam. Toward this end, PMI retained Salomon, an investment banking firm, to evaluate Stewart/Bayley's net worth and to prepare an offering memorandum on the two companies. In April 1986, Salomon requested various financial documents from Stewart/Bayley, including any internal earnings projections that had been prepared on the two companies. In response, Stewart/Bayley's management sent financial forecasts to Salomon that predicted that Stewart/Bayley's earnings would fall from $4.8 million in 1986 to $2.9 million in 1987, and

would stay approximately at that level through 1990 (the "April projections").

After PMI learned of the pessimistic April projections, it asked Salomon not to include them in the offering memorandum on Stewart/Bayley. According to Folger Adam, PMI was afraid that if the projections were included in the offering memorandum, the sale price for the two companies would substantially decrease. PMI vigorously refutes this interpretation, and argues that it sought to exclude the April projections from the offering memorandum because the projections were "conservative" estimates of Stewart/Bayley's earnings potential that did not accurately reflect the two companies' future prospects. The parties do agree, however, that, although the April projections were included in an early version of the offering memorandum, they were omitted from the final version, which instead stated that "management believes that net sales and net income for fiscal year 1986 should increase over 1985 levels and remain strong in the future."

After receiving the final offering memorandum, Folger Adam asserts that it contacted PMI and Salomon in order to obtain any earnings projections that had been performed on Stewart/Bayley, but was informed by both appellees that no such forecasts had ever been prepared. Folger Adam also contends that Salomon stated that, although no formal earnings projections had been performed, Stewart/Bayley's earnings were estimated to remain around $5 million a year for the foreseeable future. PMI and Salomon flatly reject these allegations.

In August 1986, Folger Adam signed a letter of intent to purchase Stewart/Bayley, and began to perform its own program of due diligence on the two companies. As part of this investigation, Folger Adam requested that PMI analyze Stewart/Bayley's 1987 earnings potential. This request was considered at an October 1, 1986 meeting of Stewart/Bayley's Board of Directors. According to Folger Adam, Stewart/Bayley's managers suggested at the meeting that 1987 earnings be projected at $2.4 million (the "October projections"), but PMI's president refused such an "unacceptable" figure, and instead insisted that Folger Adam be told that 1987 earnings would be between

$3.8 and $4.2 million. PMI concedes that the $2.4 million figure was mentioned at the meeting, but argues that it was simply an arbitrary figure meant to initiate discussion, and that the entire board at the end of the meeting agreed that a more accurate projection was between $3 and $4 million.

Thereafter, PMI informed Folger Adam that the 1987 earnings were projected to be approximately $4 million. Folger Adam contends that upon receiving the information, it became concerned because the figure was significantly less than 1986 earnings. Folger Adam alleges that to quell this concern, PMI informed it that the $4 million figure was a product of management's conservatism, and that a more realistic projection for 1987 earnings would be approximately $5 million. PMI disagrees that it ever made any such statement.

In December 1986, after PMI gave Folger Adam written confirmation of the $4 million forecast, Folger Adam closed on its purchase of Stewart/Bayley for $28.5 million. Immediately thereafter, Folger Adam discovered that Stewart/Bayley's earnings were declining. In fact, the actual operating income for the two companies for 1987 was approximately $500,000, nearly one-eighth of the $4 million projection that PMI had provided to Folger Adam before the deal was consummated. Although appellees disclaim any responsibility for this precipitous decline in Stewart/Bayley's earnings, they do concede that Folger Adam did not learn of the pessimistic April 1986 projections until July 1987, approximately seven months after the sale had been consummated.

After Folger Adam discovered the April and October projections, it initiated this suit on the ground that appellees had offered and sold Stewart/Bayley by means of oral misrepresentations and a misleading offering memorandum, in violation of Section 12(2) of the Security Act of 1933, 15 U.S.C. § 77l(2), Section 10(b) of the Security Act of 1934, 15 U.S.C. § 78j; and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5.[1]

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[1] The complaint also alleged various state law claims, including breach of contract and fraudulent misrepresentation, that are not at issue on this appeal.

The central issue at trial was whether the April and October projections constituted material facts that had to be disclosed under the federal securities laws. After seven weeks of testimony, the district court instructed the jury on the law, including the law on materiality,[2] and directed them to answer several interrogatories, the first of which asked whether appellees had misstated or omitted any material facts in connection with the sale of Stewart/Bayley. Because the jury found that appellees had not made any material misstatements or omissions, the court instructed the jury to stop deliberating, and entered judgment in favor of appellees.

Folger Adam appeals the district court's judgment on the ground that the court misinstructed the jury regarding on the issue of materiality. Appellees respond that the materiality instruction was proper and that, in any event, their conduct was not actionable as a matter of law.

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[2] The full charge on materiality was as follows:

> In the context of this case, a fact is material when there is a substantial likelihood that, if a reasonable investor had learned of the falsity of the misstatement of fact or the existence of the omitted fact, that investor would have regarded the total mix of information available to have been significantly altered.
>
> By total mix of information, I mean all the information from any source available to such investor at the time it made a decision.
>
> I note that a number of the witnesses were asked whether they would have wanted to know certain information under certain circumstances. An answer to such a question is by no means determinative of whether or not materiality as I defined it has been established. That certain information would have satisfied the curiosity of any particular investor has nothing to do with the question of materiality unless you find a substantial likelihood that the information supplied in satisfaction of such curiosity would have had, in the view of a reasonable investor, the effect of significantly altering the total mix of information available and thus would have caused it to alter its views as to the desirability of proceeding with the purchase.
>
> In other words, information is material when there is a substantial likelihood that a reasonable investor in Folger Adam's circumstances would have regarded the total mix of information available to it—all the information gleaned from the due diligence investigation, publicly available information about the companies and of the detention industry in which they operated—to have been significantly altered, had it discovered that management's views of the companies' prospects were inaccurate or had the lower figures been disclosed.

Tr. 3592-94.

DISCUSSION

The Supreme Court has alternatively defined a material fact as that which a reasonable investor would view "as having significantly altered the 'total mix' of information made available" or that which there is a substantial likelihood that a reasonable investor "would consider . . . important in deciding how to vote." *TSC Indus. Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976). No matter how stated, however, it is well-established that a material fact need not be outcome-determinative; that is, it need not be important enough that it "would have caused the reasonable investor to change his vote." *Id.* Rather, the information need only be important enough that it "would have assumed actual significance in the deliberations of the reasonable shareholder." *Id.*

In this case, the district court's four-paragraph materiality charge did not adequately inform the jury of the proper meaning of materiality, and, in fact, may have affirmatively misled the jury on the correct standard. First, although the charge repeatedly stated that a material fact is one that would alter the total mix of available information, *see supra* note 2, it never mentioned, much less highlighted, the critical distinction between facts that are important enough to assume actual significance in a reasonable investor's deliberations, and facts that are so important that they would change an investor's decision whether to consummate the transaction.[3] In our view, it is doubtful that the jury,

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[3] In this case, the subtle distinction between information that is outcome-determinative and that which is important, but not outcome-determinative, is critical. After all, a reasonable investor in Folger Adam's position may well have viewed the pessimistic April and October projections as important enough to assume actual significance in its investment deliberations—*i.e.*, in determining how much it was willing to pay for Stuart/Bayley, or how it was going to structure the transaction—but not necessarily important enough, when viewed as part of the total mix of available information, to change its decision on whether to consummate the transaction. *See, e.g., SEC* v. *Natl Student Marketing Corp.*, 457 F. Supp. 682, 708-09 (D.D.C. 1978) (noting that earnings projections are material if a reasonable investor would consider them "important and significant," even if the information would not change the investor's decision on whether to consummate the transaction).

which is presumed to be unfamiliar with legal jargon and probably has little or no experience in the securities industry, would comprehend that a fact that would significantly alter the total mix of available information is simply a fact that would "have assumed actual significance in the deliberations of the reasonable shareholder." *TSC*, 426 U.S. at 449. Rather, we think that the jury would take the "total mix" formulation to mean that a material fact is one that would cause a reasonable investor to change her decision on whether to consummate a transaction. As a result, the jury may erroneously have believed that appellees' conduct could constitute an omission or misstatement of material fact only if a reasonable investor in Folger Adam's position would have canceled the Stewart/Bayley transaction had it been aware of the April and October earnings projections.[4]

The possibility that the jury may have erroneously believed that an omission or misstatement of material fact must be outcome-determinative is compounded by the district court's statement that a material fact "would have caused [a reasonable investor] to alter its views as to the desirability of proceeding with the purchase." In our view, this phrase is susceptible to two different interpretations. On the one hand, if the jury construed the term "alter"' to mean a slight variation rather than a complete change,[5] it would have properly understood the disputed phrase to mean that a material fact is one that would affect a reasonable investor's deliberations without necessarily changing her ultimate investment decision. However, if the jury construed "alter" to mean a complete change rather than a slight variation—a likely possi-

[4] We do not mean to suggest that the "total mix" formulation—which is at the core of the Supreme Court's understanding of materiality—is improper in a charge on materiality. Rather, we hold only that in a case such as this—where materiality is likely to turn on the distinction between information that would assume actual significance in a reasonable investor's deliberations and information that would be outcome-determinative—the "total mix" formulation must be explained in a manner that highlights that subtle distinction to the jury.

[5] To "alter" means "to cause to become different in some particular characteristic . . . without changing into something else." Webster's Third New International Dictionary at 63 (16th ed. 1971).

bility given the colloquial usage of the term[6]—it could have erroneously believed that a material fact must change a reasonable investor's decision on whether to consummate a transaction. Accordingly, because the jury may have been led to believe that a material fact must be outcome determinative, we find that the charge was erroneous. *See Paolillo* v. *Dresser Indus., Inc.*, 865 F.2d 37, 40 (2d Cir.), *modified on other grounds*, 884 F.2d 707 (2d Cir. 1989) (finding a jury charge erroneous because it could not be said for certain that it did not cause the jury to apply the wrong legal standard); *Norfleet* v. *Isthmian Lines, Inc.*, 355 F.2d 359, 362-63 (2d Cir. 1966) ("The appellate function of this court is to satisfy itself that instructions . . . show *no tendency* to confuse or mislead the jury as to the principles of law which are applicable.") (emphasis added).[7]

Our conclusion that the charge in this case was erroneous is not affected by appellees' observation that we have employed similar language in the past to describe the materiality requirement. *See, e.g., Wilson* v. *Great Am. Indus., Inc.*, 855 F.2d 987, 992 (2d Cir. 1988) ("'[M]aterial facts . . . may affect the desire of investors to buy, sell, or hold the company's securities.'" (quoting *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969)); *Elkind* v. *Liggett & Myers, Inc.*, 635 F.2d 156, 166 (2d Cir. 1980) (noting that a relevant question in determining whether information is material is whether it "would have been likely to affect the decision of potential buyers and sellers"); *Harkavy* v. *Apparel Indus., Inc.*, 571 F.2d 737, 741 (2d Cir. 1978) (also quoting *Texas Gulf Sulphur Co.*, 401 F.2d at 849). First, the operative term in these cases was "af-

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6 A common synonym for "alter" is "change." American College Dictionary 37 (1970).

7 In this regard, we disagree with the district court's decision to deny Folger Adam's motion for judgment notwithstanding the verdict on the ground that the "mere fact that one might alter one's views as to the desirability of proceeding with a transaction, did not necessarily mean that such alteration would ultimately result in a different course of action." As noted, the proper inquiry is not whether the jury *necessarily* misconceived the meaning of the materiality charge, but whether, given the ambiguity in the charge, the jury *might* have misunderstood the controlling standard of law.

fect," which, unlike "alter," does not suggest that material information must change a reasonable investor's decision on whether to consummate a transaction. Second, because the materiality determination in *Wilson*, *Elkind*, and *Harkavy* did not turn on the subtle distinction between information that may affect a reasonable investor's deliberations and information that would dissuade that investor from consummating the transaction, we fail to perceive how these cases are instructive in a situation such as this, where that distinction may well be dispositive.

In spite of the error in the jury charge, appellees argue, there is no need for a new trial. Rather, appellees insist that they are entitled to a directed verdict because their actions, as a matter of law, did not constitute securities fraud. First, PMI and Salomon argue that because the April and October earnings projections were not compiled with "substantial certainty," they were not material facts that needed to be disclosed in the course of the Stewart/Bayley transaction. Because Folger Adam's witnesses may be able to persuade a correctly instructed jury that the April and October projections were accurate statements of Stewart/Bayley's future that were intentionally concealed, however, we cannot find that appellees' conduct was immaterial as a matter of law. *See Elkind* v. *Liggett & Myers, Inc.*, 635 F.2d 156, 164 n.12 (2d Cir. 1980) ("Liability may follow where management intentionally fosters a mistaken belief concerning a material fact, such as its evaluation of the company's progress and earnings prospects."); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc) ("[M]aterial facts include . . . information disclosing the earnings and distributions of a company.")[8]

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[8] In this regard, PMI's reliance on cases that have found certain internal earnings projections to be immaterial as a matter of law, *see, e.g.*, *Weilgos* v. *Commonwealth Edison Co.*, 892 F.2d 509, 516 (7th Cir. 1989); *Panter* v. *Marshall Field & Co.*, 646 F.2d 271, 292-93 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981), is inapposite. In those cases, there was no dispute that the earnings projections at issue were hastily drawn, rough estimates that were generated for internal use only. In contrast, here there is substantial dispute as to the quality of the April and October projections.

Second, Salomon claims that because its only role in the transaction was to prepare the offering memorandum on Stewart/Bayley, it cannot be held legally responsible for any securities laws violations. We note, however, that Folger Adam's witnesses testified at trial that Salomon was more than an innocent player in the alleged deception concerning Stewart/Bayley's earnings projections. According to these witnesses, Salomon not only agreed to exclude the pessimistic April projections from the final offering memorandum, but also affirmatively misled Folger Adam by stating that Stewart/ Bayley's future earnings would remain at approximately $5 million a year. Assuming that such statements were made, we cannot conclude that a reasonable investor in Folger Adam's position, knowing that Salomon had performed extensive due diligence on Stewart/Bayley and had prepared the offering memorandum on the two companies, would not have factored them into its deliberations on whether to purchase Stewart/ Bayley.

In conclusion, although we are sympathetic to appellees' claim that Folger Adam is a sophisticated investor that conducted its own investigation before deciding to purchase Stewart/Bayley, we find that reasonable minds could differ as to whether a reasonable investor in Folger Adam's position would have considered appellees' omissions and alleged misstatements "significant, even as part of a larger 'mix' of factors to consider in making his investment decision." *Basic Inc.* v. *Levinson*, 485 U.S. 224, 234 (1988) (quoting *TSC Indus., Inc.*, 426 U.S. at 448-9). As a result, we reverse the judgment of the district court and remand for a new trial in which the jury is clearly instructed that a fact can be material if it would have assumed actual significance in a reasonable investor's deliberations, even if it would not have changed the investor's decision on whether to consummate the transaction.

APPENDIX B

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

FOLGER ADAM COMPANY, Plaintiff, —against— PMI INDUSTRIES, INC., CONTROL SYSTEMS CORPORATION, WEDGE GROUP, INC. AND SALOMON BROTHERS INC, Defendants.	**MEMORANDUM & ORDER** 87 Civ. 9272 (WK)

WHITMAN KNAPP, D.J.

Defendants PMI Industries, Inc., Control Systems Corporation, Wedge, Inc. (collectively, the "Texas defendants") and Salomon Brothers Inc ("Salomon") move for summary judgment. Plaintiff Folger Adam Company ("Folger") cross-moves for summary judgment based on its § 12(2) claim. For reasons which follow, we grant defendants' motions with respect to the negligent misrepresentation claim. We otherwise deny all motions.

BACKGROUND

This case arises out of Folger's December 1986 purchase of two detention equipment companies, Stewart-Decatur Security Systems Inc. ("Stewart") and William Bayley Company ("Bayley"), from the Texas defendants for $28.5 million. Folger alleges that, in connection with the sale, the Texas defendants and investment banker Salomon made material misrepresentations in violation of § 10(b) of the 1934 Securities Exchange Act, 15 U.S.C. § 78(b) and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 and § 12(2) of the 1933 Securities Exchange Act, 15 U.S.C. § 771(2). Folger further contends that

evidence of the alleged misrepresentations establishes state law claims of fraudulent misrepresentation, breach of contract, indemnity, estoppel and negligent misrepresentation and entitle it to punitive damages.

Although the events leading up to the sale, the terms of the sale itself, and its aftermath have been thoroughly described in the rather lengthy briefs, affidavits, local rule 3(g) statements and exhibits submitted in support of and opposition to the motions,[1] we here focus on what we think is the crux of the case: certain markedly pessimistic financial projections prepared by Stewart and Bayley managers, provided to Salomon, but ultimately not included in the selling memorandum or otherwise made available to Folger.

A. The Projections[2]

Upon learning that the companies were up for sale, Robert Nelson, president of both Stewart and Bayley; Ralph Chalk, controller of Stewart; Louis Maggs, chief operating officer of Bayley; and John Hartig, controller of Bayley, prepared projections as part of their consideration of a possible management leveraged buy-out. According to these projections, which were dated April 8, 1986, the companies' 1987 earnings would fall off to $2.7 million from the budgeted 1986 earnings of $4.8 million, a decline of approximately 40%, and would not significantly rebound in the following four years.

On April 17, 1986, Salomon, which had been retained as investment banker for the anticipated sale, requested that, in order to facilitate the "due diligence" investigation, Nelson provide, among other things, any management forecasts for the period 1986-1990. On April 30, Nelson sent Salomon projections that had been revised only slightly upward from those that had been prepared less then two weeks earlier: 1987 sales were predicted to be $2.9 million; 1988 sales, $2.3 million; 1989 sales, $2.5 million; 1990 sales, $2.6 million.

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[1] Approximately 16,400 sheets of 8 1/2 x 11 paper were employed to discuss whether or not there was an issue of material fact in this case. If the sheets were laid end to end, the resulting path of paper would extend some 2.85 miles.

[2] Most of the facts summarized below are undisputed, although of course the parties would have us draw widely divergent inferences.

On June 6, 1986, Salomon sent a first draft of a selling memorandum to the Texas defendants, which were the corporate parents of Stewart and Bayley,[3] and to the management of Stewart and Bayley. Incorporated in the draft were the projections that Nelson had provided to Salomon. Upon receiving the draft, PMI president Eldon Nuss telephoned Salomon and directed that the projections be removed from subsequent drafts. On June 16, Robert Nelson, the Stewart and Bayley president who had initially given the projections to Salomon, returned to Salomon a marked-up draft that incorporated changes suggested by the management of Stewart and Bayley. That mark-up left undisturbed the projections that Nuss had ordered deleted. On June 20, Alan Goertz, the chief financial officer of PMI, sent Salomon the Texas defendants' suggested changes, including Nuss' direction that the projections be eliminated. In place of the projections, the Texas defendants' mark-up included a description of what it characterized as the bright future of the detention market in general. Salomon issued a final memorandum that incorporated the changes and stated that Stewart and Bayley's budgets for 1986 indicated that the companies would have a combined operating income of $4.8 million. The memorandum also stated that "[m]anagement believes that net sales and net income for fiscal year 1986 should increase over 1985 levels and remain strong in the future."

During the summer of 1986, Salomon sent the memorandum to potential buyers including the investment firm Adler & Shaykin, which was Folger's majority shareholder. On August 25, 1986, after Leonard Shaykin of Adler & Shaykin had made a preliminary visit to Stewart and Bayley and had conducted initial discussions with Nuss, a letter of intent for the sale of the two companies to Folger was signed.

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3 PMI, Wedge's wholly-owned subsidiary, was formed in 1975 by Eldon Nuss and others for the purpose of acquiring metals manufacturing companies. It acquired Stewart in 1978 and Bayley in 1977. PMI was in Houston, Texas; Stewart was in Erlanger, Kentucky; Bayley was in Springfield, Ohio. Control Systems Corporation, PMI's wholly-owned subsidiary, held the Stewart and Bayley stock that was ultimately sold to Folger.

Following the signing, Folger began its own investigation of the companies by, among other things, repeatedly asking for management projections of future earnings. At first, the Texas defendants denied that any such projections had been prepared. Then, on October 1, 1986, at a meeting of Bayley's Board of Directors attended by Nuss, Goertz, Nelson, Maggs, and Hartig, Folger's requests for projections were discussed. Although Nelson and Maggs said that they believed that the combined 1987 operating income for Stewart and Bayley would be $2.4 million, a figure 20% less than the one they had submitted to Salomon five months earlier, Nuss declared that Folger would be told that the 1987 operating income was projected to be $4 million. Soon after the meeting, Folger was informed that the $4 million figure did indeed represent management's projection of the companies' 1987 earnings.[4]

B. Other information available to Folger

Prior to the sale, Folger[5] conducted extensive due diligence apart from its requests for projections. It hired consultants Walter Kay Associates, Inc., Manufacturers Appraisal Company and Lloyd Thomas/Coats & Burchard Co., as well as accounting firm Arthur Young and law firm Dechert Price & Rhoads, to assist in the investigation. Folger asked for and received Stewart and Bayley financial statements and budgets for 1983-86, listings and analyses of the companies' backlogs, weekly lists of projects that the companies were bidding on and planned to bid on, the companies' own evaluations of market conditions, the workpapers for prior audits of the companies, the companies' materials contracts, listings of accounts receivable, and information about pending litigation. Folger made several visits to the plants and was able to speak with the companies' managers.

In the course of its investigation, Folger learned, among other things, that the companies had declining backlogs, had not bid any major projects in the preceding months, had many managers and sales-

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4 Nuss is not included in the selling memorandum's list of the companies' management and did not take part in the day-to-day operation of the companies.

5 "Folger," as here used, means Folger and its main stockholder, Adler & Shaykin.

people who were near retirement, and had high bonding costs. It also discovered that Stewart lacked the systems to [sic] necessary to do fifteen to twenty jobs at once, only bid jobs that required a high percentage of its own manufactured product, was poorly run, frequently experienced costly delays on projects, and had incurred substantial cost overruns on one of its projects. In addition, it learned that Bayley was dependent on a single supplier.

C. The October 14, 1986 meeting

John Quigley of Adler & Shaykin requested a meeting to discuss these issues and to propose that the purchase price be reduced from the previously agreed upon $29 million. At the meeting, which was held on October 14, 1986, the parties engaged in a "point-counterpoint" discussion: "Adler & Shaykin/Folger Adam people said they had seen a deterioration in [Stewart's and Bayley's business] prospects" and, in response, "PMI/Wedge people gave the reason why the deterioration was not so."[6] Also discussed were the companies' prospects. Heiligbrodt of Wedge and Nuss represented that, in spite of the negatives, the $4 million figure previously released as management's projection of the companies' 1987 earnings reflected the "conservatism" of management and that the real figure was closer to $5 million.

D. The sale and its aftermath

On December 17, after additional negotiations, the parties signed a Stock Purchase Agreement for all the shares of Stewart and Bayley for $28.5 million. That agreement included a boiler-plate merger clause. The transaction closed on December 22.

Folger contends that, almost immediately after it took over the two companies, it discovered that they were in far worse shape than the representations that had been made in connection with the sale had led it believe [sic].[7] Their suspicions were confirmed, it further contends,

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[6] Farrell dep. p. 431, submitted as exhibit 7 to the affidavit of Steven B. Fierson.

[7] The defendants sharply dispute plaintiff's account of the reasons for the decline of the two companies and, indeed, suggest, based on statements Folger has made in connection with its own effort to sell the companies, that there may not have been a decline at all. Loss causation is clearly an issue of fact.

when in July 1987 Donald Stading of Folger fired Nelson. After Nelson had departed, Stading went through Nelson's desk and discovered the draft selling memorandum containing the undisclosed pessimistic projections.

DISCUSSION

I. Federal Securities Claims

Since the arguments with respect to the §§ 12(2)[8] and 10(b)[9] claims overlap, we address them simultaneously wherever possible.

A. Accuracy of the Representations

Salomon argues that, so far as it is concerned, the selling memorandum was accurate and complete in all material respects, because there is no indication that Salomon did not believe that "[m]anagement believe[d] that net sales and net income for fiscal year 1986 should increase over 1985 levels and remain strong in the future." The facts summarized above could suggest a contrary inference: that Salomon knew that the Texas defendants and Stewart and Bayley management disagreed about the companies' prospects and that the Texas defendants, because they owned Stewart and Bayley, were able to suppress the views of the companies' managers and replace them with their own. However, what Salomon actually believed is an obvious question of fact precluding summary judgment in favor of any party.

B. Scienter

The issue of scienter, which requires an evaluation of credibility, is generally unsuited to resolution on summary judgment. *Wechsler* v. *Steinberg* (2d Cir. 1984) 733 F.2d 1054, 1058. "In a § 10(b) action, a court may not grant such relief to the defendants on the ground of scienter unless plaintiff has failed to present facts that can support an inference of bad faith or an inference that defendants acted with an intent to deceive." *Id.* at 1059. That defendants released "management" projections far rosier than those the managers at Stewart and Bayley

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[8] Count one.

[9] Count two.

had actually prepared certainly could support an inference adverse to defendants. Defendants' arguments about their justifications for so doing may prove convincing to a jury, but they do not support summary judgment.

C. Materiality

A fact is material where there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc.* v. *Northway, Inc.* (1976) 426 U.S. 438, 449. "The role of the materiality requirement is . . . to filter out essentially useless information that a reasonable investor would not consider significant, even as part of a larger 'mix' of factors to consider in making his investment decision." *Basic Inc.* v. *Levinson* (1988) 485 U.S. 224, 234.

Both the Texas defendants and Salomon urge that, if any misrepresentation was made, it was not material given the "total mix" of information available to plaintiff. They go on to cite a wealth of sources that might have led plaintiff to the conclusion that the companies were a poor risk and that the projections in the selling memorandum should be discounted. Plaintiff, in opposition to the defendants' motions and in support of its own, insists that, regardless of what other information it had, the projections would have been vital to its decision had they been disclosed. There is no basis for choosing one and rejecting another of these contentions and, thus, no basis for granting summary judgment for any party on the materiality issue.

D. Folger's Alleged Knowledge

Defendants' argument that they cannot be held liable because plaintiff knew of the facts that gave rise to the pessimistic projections is a close cousin of their materiality argument. There is, as discussed above, an issue of fact as to whether plaintiff reasonably would have found the views of Stewart and Bayley's managers about the companies' future earnings significant, given the other information to which they had access. It is not enough to say that plaintiff could have recon-

structed those projections itself, since it reasonably may have considered the projections significant precisely because they were prepared by those who actually ran the companies.

E. Reliance

Since an injured party would be hard put to prove it relied on something that was not disclosed, "[r]eliance is presumed in a fraud case based on omissions of material fact." *Whitbread (US) Holds, Inc.* v. *Baron Philippe De Rothschild* (S.D.N.Y. 1986) 630 F. Supp. 972, 978, *citing Affiliated Ute Citizens* v. *United States* (1972) 406 U.S. 128. *See also Miller* v. *Grigoli* (S.D.N.Y. 1989) 712 F. Supp. 1087, 1094. As discussed above, materiality presents a factual issue in this case. Thus, there is a rebuttable presumption of reliance.

Donald Stading, president of Folger, stated in an affidavit that Folger would have relied on the management projections had they been supplied. *See* Stading Aff. ¶¶ 3-5.[10] In the context of the factual allegations discussed above, that statement alone precludes awarding summary judgment to defendants.

F. Applicability of § 12(2)

The Texas defendants argue, based on their reading of the legislative history and " 'a growing body of federal district court decisions,' "[11] that section 12(2) of the 1933 Act applies only to the sale of stock in an initial public offering. Unfortunately for the Texas defendants, the Supreme Court five years ago decisively rejected a narrow interpretation of Congressional intent and, without making any distinction between "newly created" securities and those existing prior to sale, declared that § 12(2) applies to the private sale of a company's stock. *See Gould* v. *Ruefenacht* (1985) 471 U.S. 701 (sale of stock previously held by company president); *Landreth Timber Co.* v. *Landreth* (1985) 471 U.S. 681 (sale of stock previously held by owners of family business). The "growing body" of district court cases to which the

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[10] Submitted as exhibit 110 to the affidavit of Steven B. Fierson.

[11] *Mix* v. *E.F. Hutton & Co., Inc.* (D. D.C. 1989) 720 F. Supp. 8, 10.

Texas defendants refer are clearly inapposite. As plaintiffs point out, some deal with situations in which plaintiffs were not able to demonstrate that their purchases of stock in the secondary market were made in reliance on an allegedly misleading registration statement of [sic] prospectus. *See, e.g., Ackerman* v. *Clinical Data, Inc.* (S.D.N.Y. 1985) Fed. Sec. L. Rep. (CCH) ¶ 92,207; *Klein* v. *Computer Devices, Inc.* (S.D.N.Y. 1984) 591 F. Supp 270, 277-78; *Gross* v. *Diversified Mortgage Investors* (S.D.N.Y. 1977) 431 F. Supp. 1080, 1095, *aff'd without opinion*, (2d Cir. 1980) 636 F.2d 1201. Others concern claims by investors against their brokers for the mishandling of the trading of publicly-held securities in their brokerage accounts. *See, e.g., Mix* v. *E.F. Hutton & Co., Inc.* (D.D.C. 1989) 720 F. Supp. 8, 10; *Panek* v. *Bogucz* (D.N.J. 1989) 718 F. Supp. 1228, 1231-32; *Strong* v. *Paine Webber* (S.D.N.Y. 1988) 700 F. Supp. 4, 5; *SSH Co. Ltd.* v. *Shearson Lehman Bros. Inc.* (S.D.N.Y. 1987) 678 F. Supp. 1055, 1058.

Salomon makes a similarly unconvincing argument, contending that § 12(2) does not apply because the selling memorandum culminated in the letter of intent, which stated that the parties "contemplated [Folger's] purchase of all of the *assets*"—not stock—of Stewart and Bayley (emphasis added). Regardless of what the letter of intent said, the Texas defendants ultimately sold their Stewart and Bayley stock to plaintiff. Since plaintiff has presented an issue of fact as to whether it purchased the stock in reliance on the selling memorandum prepared in part by Salomon, there is no basis for summary judgment on this ground.

G. Stock Purchase Agreement Merger Clause

Defendants cannot immunize themselves from federal securities claims with the sort of general merger clause[12] that was included in the Stock Purchase Agreement. See § 29(a) of Securities and Exchange

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[12] The clause provides:

> 10.10 *Entire Agreement.* This Agreement and the Exhibits and Schedules hereto, each of which is incorporated herein, set forth all of the promises, covenants, agreements, conditions and undertakings between the parties hereto with respect to the subject matter hereof, and supersede all prior and contemporaneous agreements and understandings, inducements or conditions, express or implied, oral or written.

Act of 1934, 15 U.S.C. § 78cc(a); *ECL Industries Inc.* v. *Ticor* (S.D.N.Y. 1986) [1986-87] Fed. Sec. L. Rep. (CCH) ¶ 92,887; *Lanza* v. *Drexel & Co.* (S.D.N.Y. 1970) [1970-1971] Fed. Sec. L. Rep. (CCH) ¶ 92,826, *aff'd*, (2d Cir. 1973) 479 F.2d 1277.[13]

II. State Law Claims

A. Fraudulent Misrepresentation[14]

Plaintiff expressly disclaims any argument that it is entitled to recover simply because the companies did not live up to the projections that were made available.[15] Instead, its case centers on its allegation that defendants "communicated to Folger Adam a very positive view of the companies future prospects [sic], *while actively concealing and misrepresenting management's dismal view of those prospects.*"[16] In other words, the issue is not projections themselves, but rather whether or not they accurately represented the views of the management of Stewart and Bayley. Accordingly, *Burgundy Basin Inn* v. *Watkins Glen Grand Prix* (4th Dep't 1976) 51 A.D.2d 140, 379 N.Y.S.2d 873 and similar cases deeming non-fraudulent a "'prophesy and prediction of something which it is merely hoped or expected will occur in the future'" are not applicable here. *Id.* at 879, *quoting Channel Master Corp.* v. *Aluminum Ltd. Sales, Inc.* (1959) 4 N.Y.2d 403, 408, 176 N.Y.S.2d 259, 263.

As discussed *supra*, there remain issues of fact with respect to scienter, misrepresentation, materiality, justifiable reliance and loss causation. There is thus no basis for granting summary judgment on the fraud claim.

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[13] Nor are they insulated from common law fraud claims. *See Hobart* v. *Schuler* (1982) 55 N.Y.2d 1023, 449 N.Y.S.2d 479; *Barash* v. *Pa. Terminal Real Estate Publishing Co.* (1970) 26 N.Y.2d 77, 308 N.Y.S.2d 649.

[14] Count three.

[15] Pl. Br. in Opposition, pp. 1-2.

[16] *Id.* at 2. (emphasis in the original)

B. Breach of Contract[17] and Indemnification Claims[18]

The first amended complaint alleges that PMI and CSC "breached their obligations under the [Stock Purchase] Agreement,[19] including, but not limited to, the representations, warranties and indemnification provisions . . . ."[20] Nowhere does plaintiff further elaborate on the substance of its breach of contract claim. We assume, however, that it is predicated on §§ 2.28 and 8.01 and discuss those sections *seriatim.*

The first, Section 2.28 of Article II, "Representations and Warranties of CSC and PMI," does not provide any basis for recovery. It warrants that the Stock Purchase Agreement and any "exhibit, document, statement, certificate or schedule furnished to Bayer pursuant hereto" do not contain any material misrepresentation or omission. Since plaintiff has not suggested that any particular clause of the contract itself contains a misrepresentation, it has made no allegation that Section 2.28 was breached.

The second, Section 8.01 of Article VIII, "Indemnification and Insurance," which also forms the basis of the indemnification claim, does provide a basis for recovery. It provides in pertinent part:

> (a) *Indemnification by CSC and PMI.* CSC and PMI shall jointly and severally indemnify, defend and hold harmless Buyer and the Companies [Stewart and Bayley] from and against:
>
> (i) **any loss,** liability, claim, obligation, damage or deficiency (collectively, "Damages") **arising out of or resulting**

[17] Count four.

[18] Count five is entitled "Guaranty and Indemnification." In light of plaintiff's concession, noted *supra,* that it does not directly seek recompense for the companies' failure to live up to the projections made available and in light of the uncontradicted fact that plaintiff attempted to bargain for but failed to receive certain guarantees in the Agreement, we construe count five to in fact include only a claim for indemnification.

[19] The Stock Purchase Agreement can be found at Exhibit 1 of the Texas Defendants' 3(g) Statement.

[20] First Amended Complaint, ¶ 66.

> **from any misrepresentation,** breach of warranty or nonfulfillment of any agreement on the part of CSC and PMI **contained in this Agreement or in any statement or certificate furnished or to be furnished to Buyer pursuant hereto or in connection with the transactions contemplated hereby . . . .** (boldface added)

This clause appears to provide for indemnification for loss sustained as a result of *any* misrepresentation made in connection with the deal, not only for misrepresentations that might have been made in the contract itself.

CSC and PMI argue that the merger clause explicitly excludes all representations not contained in the Agreement. Whatever effect the merger clause may have, however, it cannot be read to abrogate a clause of the contract itself. Moreover, although it states that the Agreement and its exhibits and schedules incorporate "all of the promises, covenants, agreements, conditions and undertakings" and "supersede all prior and contemporaneous agreements and understandings, inducements or conditions, express or implied, oral or written," the merger clause nowhere provides that they include all *representations* or supersede any previous *representations*. For these reasons, we do not grant summary judgment on the breach of contract and indemnity claims.

C. Estoppel and Negligent Misrepresentation[21]

"Equitable estoppel requires clear and convincing proof that the party against whom estoppel is directed misrepresented or concealed material facts, with knowledge of the real facts, and with the intention that the other party act in reliance upon the disingenuous conduct and that the party seeking to invoke estoppel detrimentally relied in excusable ignorance of the true facts [sic]." *Central Federal Savinas F.S.B. v. Laurels Sullivan County Estates Corp.* (3d Dep't 1989) 145 A.D.2d 1, 6, 537 N.Y.S.2d 642, 645. The Texas defendants move against plaintiff's estoppel claim "for the same reasons set out with respect to

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[21] Count six.

plaintiff's federal and common law fraud claims."[22] We deny their motion for the same reasons we denied their motions with respect to those claims, and turn to the negligent misrepresentation claim.

"[A] negligent statement may be the basis for recovery of damages, where there is carelessness in imputing of words upon which others were expected to rely and upon which they did act or failed to act to their damage . . . ." *White* v. *Guarente* (1977) 43 N.Y.2d 356, 362-63, 401 N.Y.S.2d 474, 478. The statement is not actionable, however, unless the party making it is bound by some relation of duty to the plaintiff. *Id.* Claims for negligent misrepresentation ordinarily do not arise from a buyer-to-seller relationship, absent some showing of a special relationship involving trust and reliance. *See, e.g., Accusystems Inc.* v. *Honeywell Information Systems* (S.D.N.Y. 1984) 580 F. Supp. 474; *Dorsey Products Co.* v. *United States Rubber Co.* (1st Dep't 1964) 21. A.D. 866, 867, 251 N.Y.S.2d 311, 313. Plaintiff has failed to provide any support for the conclusion that its relationship with the Texas defendants differed in any significant respect from the usual one between buyer and seller and we thus grant the Texas defendants summary judgment on the negligent misrepresentation claim.

Nor has plaintiff shown any factual basis for the conclusion that plaintiff would have been justified in placing in Salomon the degree of trust and confidence necessary to sustain a claim for negligent misrepresentation. Salomon served as investment banker for the sellers and did not, in the course of preparing the selling memorandum and participating in negotiations, itself opine as to the companies' soundness. Salomon did not give a legal opinion as did the lawyers held liable for negligent misrepresentation in *Vereins-Und Westbank, AG* v. *Carter* (S.D.N.Y. 1988) 691 F. Supp. 704. Salomon did not prepare a financial report as did the accounting firm held liable in *Credit Alliance Corp.* v. *Arthur Anderson & Co.* (1985) 65 N.Y.2d 536, 493 N.Y.S.2d 435. Salomon did not report the results of an independent investigation as did the defendant engineers in *Ossining Union Free School District* v. *An-*

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[22] Texas Def. br. at 66 n.27.

derson LaRocca Anderson (1989) 73 N.Y.2d 417, 541 N.Y.S.2d 335. Finding no basis for imputing a special relationship, we grant summary judgment to Salomon on this claim.

D. Punitive Damages[23]

Defendants make no arguments that have not been discussed and rejected, *supra*, with respect to punitive damages.

CONCLUSION

We grant defendants' motions with respect to the negligent misrepresentation claim. We otherwise deny all motions.

SO ORDERED.

New York, New York
March 29, 1990

WHITMAN KNAPP, U.S.D.J.

[23] Count seven.

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

As a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 15th day of July, one thousand nine hundred and ninety-one.

Present: HON. JAMES L. OAKES, Chief Judge
HON. RICHARD J. CARDAMONE,
HON. J. DANIEL MAHONEY,
Circuit Judges,

FOLGER ADAM COMPANY
Plaintiff-Appellant,

v.

PMI INDUSTRIES, INC., CONTROL SYSTEMS CORPORATION, WEDGE GROUP, INC., AND SALOMON BROTHERS INC.,
Defendants-Appellees.

Docket No.: 90-7798

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged and decreed that the judgment of said District Court be and it hereby is reversed and the action be and it hereby is remanded to the said district court for further proceedings in accordance with the opinion of this court with costs to be taxed against the Appellees.

Elaine B. Goldsmith,
Clerk

by: Edward J. Guardaro,
Deputy Clerk

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, in the City of New York, on the twenty-ninth day of August, one thousand nine hundred and ninety-one.

FOLGER ADAM COMPANY Plaintiff-Appellant, v. PMI INDUSTRIES, INC., CONTROL SYSTEMS CORPORATION, WEDGE GROUP, INC., AND SALOMON BROTHERS INC., Defendants-Appellees.	Docket No.: 90-7798

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by defendants-appellees, PMI INDUSTRIES, INC., CONTROL SYSTEMS CORPORATION, WEDGE GROUP, INC. and SALOMON BROTHERS INC.,

Upon consideration by the panel that heard the appeal, it is

Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

ELAINE B. GOLDSMITH
Clerk

(2)

No. 91-570

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

PMI INDUSTRIES, INC., CONTROL SYSTEMS CORPORATION, WEDGE GROUP, INC. and SALOMON BROTHERS INC,
Petitioners,

v.

FOLGER ADAM COMPANY,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF FOR RESPONDENT IN OPPOSITION

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QUESTION PRESENTED *

The District Court instructed the jury in this case that information is not material under the federal securities laws unless it "would have caused [a reasonable investor] to alter its views as to the desirability of proceeding with the purchase."

The question presented is whether, as the Second Circuit held, this definition of materiality improperly departed from this Court's definition of materiality in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976), and *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), and was likely to be misleading under the circumstances of this case.

* The first question presented by petitioners is not properly before this Court because it was not raised in or decided by the Court of Appeals.

PARTIES TO THE PROCEEDING

All of the parties to the proceeding are identified in the caption.*

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* The following information is provided pursuant to this Court's Rule 29.1: respondent Folger Adam Company ("Folger Adam") has two wholly-owned subsidiaries, Stewart-Decatur Security Systems, Inc. and The William Bayley Company. Folger Adam is a privately-held company.

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STATEMENT OF THE CASE

In March, 1986, defendant Salomon Brothers Inc ("Salomon") was retained by defendant Wedge Group, Inc. ("Wedge") for the purpose of selling two of Wedge's subsidiaries, Stewart-Decatur Security Systems, Inc. ("Stewart") and The William Bayley Company ("Bayley"). Wedge is an investment company, engaged in the buying and selling of companies, and is the parent of defendant PMI Industries, Inc. ("PMI"). PMI is a holding company which was, in turn, the parent of Stewart and Bayley.

Soon after it was retained, Salomon began preparing an offering memorandum to be distributed to potential buyers of Stewart and Bayley (the "Salomon offering memorandum"). Toward that end, Salomon requested

that Stewart and Bayley's management send Salomon certain information, including earnings projections. In response, the Stewart and Bayley management sent projections to Salomon that predicted that those companies' earnings would fall from $4.8 million in 1986 to $2.9 million in 1987; $2.3 million in 1988; $2.5 million in 1989; and $2.6 million in 1990.

These nosedive projections were included in Salomon's initial drafts of the offering memorandum. At the insistence of Wedge and PMI, however, the projections were removed from the version of the Salomon offering memorandum that was distributed to potential buyers. In their place appeared a reference to $4.8 million in budgeted earnings for 1986, and the representation that "management believes that net sales and net income for fiscal year 1986 should increase over 1985 levels and *remain strong in the future.*" (Emphasis added).

Folger Adam Company ("Folger Adam") received the Salomon offering memorandum early in the summer of 1986. Soon thereafter, Folger Adam began negotiating with Wedge/PMI and Salomon for the purchase of Stewart and Bayley. During those negotiations, Folger Adam told Wedge/PMI and Salomon that it was interested in "buying an earnings stream," and Folger Adam persistently asked the sellers' representatives for earnings projections. Wedge/PMI and Salomon initially told Folger Adam that there were no earnings projections for Stewart and Bayley. In the fall of 1986, however, Folger Adam received written projections which, according to the sellers, "conservatively" predicted $4 million in earnings for Stewart and Bayley in 1987. Unbeknownst to Folger Adam, at an earlier meeting in the fall of 1986 to discuss Folger Adam's repeated requests for projections, the Stewart and Bayley management, consistent with their views expressed earlier in the year, told Wedge/PMI that earnings in 1987 would fall to $2.4 million. In response, Wedge/PMI told management

that that number was "unacceptable." Shortly thereafter, Folger Adam received the "conservative" $4 million written projections.

On December 22, 1986, Folger Adam purchased 100% of the outstanding stock of Stewart and Bayley for approximately $28.5 million. Within a few weeks after the closing, Folger Adam learned that Stewart and Bayley's earnings would fall far short of the "conservative" $4 million written projections. (In fact, the actual 1987 earnings for Stewart and Bayley were about $500,000, one-eighth of the "conservative" $4 million projections.) In July 1987, approximately seven months after the closing, Folger Adam learned for the first time of the nose-dive earnings projections that had been included in the earlier drafts of the Salomon offering memorandum, but were removed from the version of the Salomon offering memorandum sent to Folger Adam. Folger Adam also learned for the first time that the management of Stewart and Bayley had predicted on other occasions before the closing that after 1986 the earnings of those companies would decline precipitously.

In December 1987, Folger Adam filed this lawsuit in the United States District Court for the Southern District of New York. Folger Adam asserted claims under Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5; and the common law.

Before trial, Wedge/PMI and Salomon filed separate motions for summary judgment. One of the arguments advanced by Wedge/PMI in support of their motion was that Folger Adam had no Section 12(2) claim, on the ground that Folger Adam did not purchase the stock of Stewart and Bayley in an initial public offering. Although Salomon submitted more than 200 pages of briefing in support of its separate motion for summary judgment, Salomon never made such an argument in the Dis-

trict Court. The District Court denied the defendants' summary judgment motions, and expressly rejected Wedge/PMI's argument that Section 12(2) was inapplicable, as a matter of law, in this case.

A jury trial began in May, 1990. A critical issue at trial was whether the representations made to Folger Adam during the selling process, as well as the information not disclosed to Folger Adam, were material under the federal securities laws. Through the course of a seven-week trial, both sides offered evidence on that pivotal issue.[1] At the close of the evidence, after several charge conferences and over Folger Adam's strenuous objections, the District Court gave a materiality charge to the jury which included the following statement:

> That certain information would have satisfied the curiosity of any particular investor has nothing to do with the question of materiality unless you find a substantial likelihood that the information supplied in satisfaction of such curiosity would have had, in the view of a reasonable investor, the effect of significantly altering the total mix of information available *and thus would have caused it to alter its views as to the desirability of proceeding with the purchase.*

Pet. App. at 5a n.2 (emphasis added).

After the jury began deliberating, but before the transcription of the charge had been completed, the jury specifically asked to see the written charge. Upon receiving the written charge, the jury found that petitioners

[1] Petitioners contended that the concealed nosedive projections were not material on the ground that they were prepared "hurriedly" by Stewart and Bayley management, which was "conflicted." Folger Adam strongly disagreed and pointed out, *inter alia*, that petitioners themselves agreed that the Stewart and Bayley management was honest, competent, and experienced, and that, notwithstanding the purported "deficiencies" in the concealed projections, Salomon displayed them prominently in the undisclosed versions of the offering memorandum.

had not made material misrepresentations or omissions in connection with the sale of the stock of Stewart and Bayley, and the District Court entered judgment against Folger Adam.

Folger Adam filed post-trial motions for judgment notwithstanding the verdict and for a new trial, which the District Court denied on August 1, 1990.[2] In their separate briefs on appeal, neither Wedge/PMI nor Salomon raised the argument, previously made only by Wedge/PMI in the District Court, that Section 12(2) applies only to an initial public offering of securities.

On July 15, 1991, the Second Circuit reversed the judgment entered by the District Court. The panel unanimously held that Folger Adam had not received a fair trial because the District Court gave "an erroneous jury charge regarding the meaning of the materiality requirement of the federal securities laws." The Second Circuit found that, contrary to this Court's directives in *TSC Indus., Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976), and *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), the District Court had failed to make clear that information can be material to an investor without necessarily changing the investor's decision whether to consummate a transaction. The District Court's failure to instruct the jury on this critical distinction was compounded by the court's instruction that information is not material unless it "would have caused [a reasonable investor] to alter its views as to the desirability of proceeding with the purchase." In light of this instruction, the Second Circuit found that, at best, the materiality charge was likely to be misleading and confusing in the circumstances of this case.

Rehearing and rehearing en banc were denied on August 29, 1991; none of the members of the panel nor

[2] The District Court's opinion denying Folger Adam's post-trial motions is reproduced as an Appendix to this Opposition.

any other judge of the Second Circuit wished to hear reargument.

INTRODUCTION AND SUMMARY OF ARGUMENT

1. Petitioners' first question presented—whether Section 12(2) of the Securities Act of 1933 applies to the sale of securities outside of an initial public offering—is not properly before this Court and, in any event, would not be appropriate for this Court's consideration in this case.

First, petitioners concede that they never raised the Section 12(2) issue in the Second Circuit. It therefore is not properly before this Court, and there are no exceptional circumstances that would warrant this Court's review in the absence of the Court of Appeals' consideration of the issue. Second, the petition presents no conflict for this Court to resolve. Because the Second Circuit did not even consider, much less decide, the Section 12(2) issue, its decision does not and could not possibly conflict with the decision of any other court on this issue. Nor is there even any split among the other courts of appeals on this point, since the Third Circuit is the only Court of Appeals to have addressed the issue thus far. Moreover, the District Court's decision that Section 12(2) is applicable in a case like this (where Folger Adam purchased all of the stock of two privately-held companies directly from the companies' owners) is correct. The cases cited by petitioners as in conflict on this point (all but one of them district court decisions) arise in completely different factual and legal settings.

2. Nor is there any merit to petitioners' second contention, that the Court of Appeals "preclud[ed]" the use of one of the "formulations of the materiality test set forth in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976)." Pet. at 16. The District Court in this case gave an unprecedented, aberrational jury instruction on materiality, which erroneously made re-

liance the be-all and end-all of the inquiry as to materiality. The Court of Appeals explicitly endorsed the continued validity and vitality of this Court's "total mix" formulation. The Second Circuit's application of this Court's settled precedents on materiality to one specific, isolated, confusing jury instruction does not warrant review by this Court.

REASONS FOR DENYING THE WRIT

I. THIS IS NOT A PROPER CASE IN WHICH TO CONSIDER WHETHER SECTION 12(2) OF THE SECURITIES ACT OF 1933 APPLIES IN SITUATIONS OTHER THAN INITIAL PUBLIC OFFERINGS.

A. The Issue Is Not Properly Before This Court Because It Was Not Raised in or Considered by the Court of Appeals.

Petitioners each filed lengthy briefs in the Second Circuit in which they raised and argued many issues. Yet, as petitioners concede, they never made any argument on appeal that respondent could not rely on Section 12(2) on the ground that it bought the stock of Stewart and Bayley other than in an initial public offering. See Pet. at 8 n.5. Nor did the Court of Appeals address this issue in any way.

The Section 12(2) issue therefore is not properly before this Court, which repeatedly has made clear that it will not consider on a writ of certiorari an issue not raised in the court of appeals. See, *e.g.*, *Davis* v. *United States*, 110 S. Ct. 2014, 2024 (1990); *Breininger* v. *Sheet Metal Workers Int'l Ass'n Local Union No. 6*, 110 S. Ct. 424, 440 n.18 (1989); *Solorio* v. *United States*, 483 U.S. 435, 451 n.18 (1987); *County of Oneida, New York* v. *Oneida Indian Nation*, 470 U.S. 226, 244-45 (1985); *Delta Air Lines, Inc.* v. *August*, 450 U.S. 346, 362 (1981). The Court looks for a fully developed record, including the guidance of the court of appeals, on all

issues that it addresses. See, *e.g.*, *Browning-Ferris Indus. of Vermont, Inc.* v. *Kelco Disposal, Inc.*, 492 U.S. 257, 277 n.23 (1989); *Youngberg* v. *Romeo*, 457 U.S. 307, 316 n.19 (1982). See also 17 C. Wright, A. Miller, & E. Cooper, *Federal Practice and Procedure* § 4036, at 38-39 (2d ed. 1988 & Supp. 1991) (Court reluctant to consider an issue not addressed by the court of appeals, even if properly raised, because it would lose "the advantage of prior appellate scrutiny of the record and deliberation of the arguments").

By failing to raise the Section 12(2) issue on appeal, petitioners have deprived this Court of the Second Circuit's analysis and views on that issue. The loss is especially unfortunate because, as petitioners point out, the Second Circuit is highly regarded for its " 'preeminence in the field of securities law.' " Pet. at 19 n.11 (quoting *Zoelsch* v. *Arthur Andersen & Co.*, 824 F.2d 27, 32 (D.C. Cir. 1987)).

Thus, while this Court has the power to deviate from its general rule, "[i]t is only in exceptional cases coming [to this Court] from the federal courts that questions not pressed or passed upon below are reviewed." *Youakim* v. *Miller*, 425 U.S. 231, 234 (1976) (quoting *Duignan* v. *United States*, 274 U.S. 195, 200 (1927)). This is surely not such an exceptional case.[3] Indeed, petitioners have

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[3] The cases cited by petitioners (Pet. at 8 n.5) are radically different from this case. For example, in *Wood* v. *Georgia*, 450 U.S. 261 (1981), the Court *sua sponte* raised a due process issue arising from a possible conflict of interest involving the lawyer representing the petitioners. The issue was not raised in the lower courts, of course, since "[t]he party who argued the appeal and prepared the petition for certiorari was the lawyer on whom the conflict-of-interest charge focused." *Id.* at 265 n.5. In both *Mitchell* v. *Forsyth*, 472 U.S. 511 (1985), and *Nixon* v. *Fitzgerald*, 457 U.S. 731 (1982), this Court proceeded to address the merits of the important issues raised by the petitioners after holding that the court of appeals had improperly dismissed the appeals. Thus, although the petitioners had raised the issues and attempted to argue them

not even attempted to justify their failure to raise the Section 12(2) issue in the Court of Appeals.[4] Wedge/PMI argued the point in the District Court, but chose not to pursue it in the Second Circuit. Salomon did not think enough of the argument to raise it in either the District Court or the Court of Appeals. This previously abandoned argument "is so obviously an afterthought" as not to warrant any consideration by this Court. See *Miree* v. *DeKalb County, Georgia*, 433 U.S. 25, 33-34 (1977).[5]

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in the appellate courts, they had been prevented from doing so by that court's erroneous dismissal of the appeals.

In *Youakim*, the Court permitted petitioners to pursue on remand a claim that had not been raised in the lower courts, because the claim was similar to one that had been raised below; the district court's rulings made clear that it would have rejected the "new" claim if it had been raised; and developments in the law after the district court's rulings significantly affected the viability of the "new" claim. 425 U.S. at 234-37. In *Carlson* v. *Green*, 446 U.S. 14, 17 n.2 (1980), the Court considered an issue not raised below where the respondent did not object and where the issue was important, recurring, and had been properly raised in another case that was being held pending disposition of *Carlson*.

[4] Petitioners were, of course, entitled to urge any ground on appeal in support of the judgment in their favor, "even if the court below ha[d] rejected or not dealt with the contention." R. Stern, *Appellate Practice in the United States* 124 (2d ed. 1989). Nothing prevented petitioners from arguing in the alternative on appeal that they were entitled to judgment as a matter of law on the Section 12(2) claim. Indeed, Salomon's primary argument in the Court of Appeals was that "The Jury Instructions Are Irrelevant As To Salomon Because It Was Entitled To A Directed Verdict." While Salomon advanced a number of arguments in support of that proposition, it never even mentioned the Section 12(2) argument that it now is trying to raise in this Court, for the very first time anywhere.

[5] Petitioners argue that a writ of certiorari should issue on this question in order to "avoid a needless retrial of respondent's Section 12(2) claim." Pet. at 15. This argument, like petitioners' failure to raise the Section 12(2) issue in the Court of Appeals, fundamentally misconceives the respective roles of this Court and the lower federal courts. Petitioners should have presented to the

B. The Petition Presents No Conflict in Need of Resolution by This Court.

1. *The Court of Appeals Has Not Rendered a Decision in Conflict With That of Any Other Court of Appeals.*

Rule 10.1(a) of this Court's rules notes that a writ of certiorari may be appropriate "[w]hen a United States court of appeals has rendered a decision in conflict with the decision of another United States court of appeals on the same matter." In this case, however, the Second Circuit was not even presented with, and did not address or decide, the Section 12(2) issue as to which petitioners claim there is a conflict.

Undeterred by their own indifference to the issue in the Court of Appeals, and the absence of any ruling on the issue by that court, petitioners now seek to rely on an asserted conflict on the question between the Third and Seventh Circuits. We explain in the next section that in fact there is no such conflict. But even if there were, it would not matter. This Court's rules obviously do not contemplate that the Court will grant certiorari to resolve a conflict between other circuit courts not even addressed in or presented by the decision of the court of appeals under review.

2. *There Is No Conflict Between or Among Any Other Courts of Appeals on the Section 12(2) Issue.*

Petitioners claim that the Third Circuit in *Ballay* v. *Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir.), *cert. denied*, 112 S. Ct. 79 (1991), and the Seventh Circuit in *Short* v. *Belleville Shoe Mfg. Co.*, 908 F.2d 1385 (7th Cir. 1990), *cert. denied*, 111 S. Ct. 2887 (1991),

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Court of Appeals their argument as to the inapplicability of Section 12(2). This Court does not sit merely to correct error, particularly a claimed error of a district court, without benefit of review by the intermediate appellate court where such review was deliberately bypassed.

have considered and resolved differently the Section 12(2) issue raised in the petition. The truth, however, is that only *Ballay* addressed the Section 12(2) issue, and therefore there is no conflict between that decision and that of any other circuit court on this issue.

In *Ballay*, the Third Circuit held that no claim could lie under Section 12(2) against a brokerage firm by buyers of publicly-traded securities in the secondary market. The court explicitly noted that this question, "whether section 12(2) of the Securities Act of 1933 affords a remedy to a buyer of securities in the secondary market", was one "*not yet ruled upon by any federal appellate court.*" 925 F.2d at 684 (emphasis added).

Petitioners' argument that *Ballay* is in conflict with the Seventh Circuit's *earlier* decision in *Short* is patently frivolous. The plaintiff in *Short*, a 10b-5 case, did not even assert a Section 12(2) claim, nor could she have, since she was a seller rather than a purchaser of securities. See 908 F.2d at 1390. The Seventh Circuit did not in any way address—by way of holding, dictum, or otherwise—the Section 12(2) issue later decided by the Third Circuit in *Ballay*. Rather, in considering what statute of limitations should be applied to the plaintiff's 10b-5 claim, the Seventh Circuit briefly described the 1933 and 1934 securities Acts and made the following general statement about the 1933 Act:

> Section 12(1) deals with sales "in violation of Section 5"—that is, unregistered sales of securities required to be registered. Section 12(2) addresses all other forms of materially incorrect or misleading selling literature and oral communications in the sale of a security.

908 F.2d at 1390. This general comment, in a completely different context, does not even address the Section 12(2) issue decided in *Ballay*.

Thus, the "conflict" posited by petitioners is contrived and non-existent. *Ballay* is the only decision by a circuit

court addressing the applicability of Section 12(2) to the trading of publicly-held securities in the secondary market, and this Court already has denied certiorari in that case. 112 S. Ct. 79 (1991). There is simply no conflict among the courts of appeals for this Court to resolve.[6]

C. The District Court's Ruling, That Section 12(2) Applies to the Sale of All of a Company's Stock by the Owner of the Company, Is Correct and Not in Conflict With the Decisions Cited by Petitioners.

Wedge/PMI (but not Salomon) argued in the District Court that Section 12(2) was inapplicable because Folger Adam did not buy the stock of Stewart and Bayley in an initial public offering. The District Court rejected that argument, stating:

> Unfortunately for [Wedge/PMI], the Supreme Court five years ago decisively rejected a narrow interpretation of Congressional intent and, without making any distinction between "newly created" securities and those existing prior to sale, declared that § 12(2) applies to the private sale of a company's stock. *See Gould* v. *Ruefenacht* (1985) 471 U.S. 701 (sale of stock previously held by company president); *Landreth Timber Co.* v. *Landreth* (1985) 471 U.S. 681 (sale of stock previously held by owners of family business).

Pet. App. at 18a.

[6] Moreover, the holding of the Third Circuit in *Ballay*—that Section 12(2) does not apply to the trading by a brokerage house of publicly-traded securities in the secondary market (*e.g.*, a stock exchange)—does not even address the applicability of Section 12(2) to a case like this one, where there has been a sale of securities *by the owner of the company*. Thus, it would be extraordinary, to say the least, for this Court to consider the *Ballay* question here when it is not at issue in this case. See *Belcher* v. *Stengel*, 429 U.S. 118, 119 (1976) (dismissing writ of certiorari as improvidently granted where it appeared that the issue being considered was "not in fact presented by the record now before [the Court]"). *Accord*, *Iowa Beef Packers, Inc.* v. *Thompson*, 405 U.S. 228, 229-30 (1972).

The District Court was correct. *Gould* and *Landreth* put to rest any notion that Section 12(2) does not apply unless securities are purchased in an initial public offering. In both of those cases, like this case, there was no initial public offering. The plaintiff in *Gould* purchased 50% of the existing shares of a closely-held corporation. He asserted claims against the seller under the federal securities laws, including Section 12(2), based upon alleged misrepresentations made during the course of negotiations. Similarly, in *Landreth*, the plaintiff purchased 100% of the stock of a closely-held corporation, pursuant to an offering letter allegedly containing misrepresentations. He asserted claims against the sellers under Section 12(1) of the 1933 Act, 15 U.S.C. § 771(1).

In both *Gould* and *Landreth* this Court held that the transactions at issue—the private sale of a company via the sale of its stock—were subject to the 1933 Act. The Court rejected the so-called "sale of business" doctrine, which posited that the private sale of controlling shares of a closely-held corporation should not be treated as the sale of a "security." In *Landreth*, the Court stated that it could not agree "that the Acts [including the 1933 Act] were intended to cover only 'passive investors' *and not privately negotiated transactions involving the transfer of control to 'entrepreneurs.'*" 471 U.S. at 692 (emphasis added).[7] The Court's analysis makes clear that the 1933

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[7] Petitioners have attempted to distinguish *Gould* and *Landreth* by arguing that "[t]hose decisions stated that the issue before the Court was whether the sale of all or 50% of the stock of a company 'is a securities transaction subject to the *antifraud* provisions of the federal securities laws.'" Pet. at 14 (emphasis by petitioners) (quoting *Gould* and *Landreth*). But the Court held in *Gould* and *Landreth* that the antifraud provisions of the federal securities laws *do* apply to a private sale of all or a substantial portion of a company's stock, and the antifraud provisions of the federal securities laws *include* Section 12(2). *Akerman* v. *Oryx Communications, Inc.*, 810 F.2d 336, 344 (2d Cir. 1987); L. Loss, *Fundamentals of Securities Regulation* 248 (Supp. 1991).

Act, including Section 12(2), applies to precisely the transaction at issue in this case.[8]

The very authorities upon which petitioners rely actually belie their argument. For example, petitioners selectively quote from a statement in the House Report accompanying the 1933 Act, asserting that the "report states that the 1933 Securities Act was meant to 'affect[] only new offerings of securities . . . .'" Pet. at 12. The full text of the statement, however, reads as follows:

> The bill affects only new offerings of securities sold through the use of the mails or of instrumentalities of interstate or foreign transportation or communication. It does not affect the ordinary redistribution of securities *unless such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering.*

H.R. Rep. No. 85, 73rd Cong., 1st Sess. 5 (1933) (emphasis added). Petitioners here surely possessed "the control of the issuer" in disposing of the stock of Stewart and Bayley.[9]

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[8] Petitioners suggest incorrectly that Professor Loss endorses their position that Section 12(2) applies only to initial public offerings. See L. Loss, *Fundamentals of Securities Regulation* 887 (2d ed. 1988) ("To start with [Section 12(2)] applies to all sales of securities, *whether or not registered* . . . .") (emphasis added). The *Landreth* Court also noted Professor Loss' criticism of the sale of business doctrine, stating: "He considers that the doctrine 'comes dangerously close to the *heresy* of saying that the fraud provisions do not apply to private transactions . . . .'" 471 U.S. at 692 n.6 (emphasis added, citation omitted). Indeed, Professor Loss believes that Section 12(2) is applicable even to the sale of publicly-traded securities in the secondary market, and therefore that *Ballay* was wrongly decided. L. Loss, *Fundamentals of Securities Regulation* 247-49 (Supp. 1991).

[9] Wedge/PMI owned 100% of the stock of Stewart and Bayley. They accordingly received the entire purchase price paid by respondent for that stock. As the owners of the Stewart and Bayley stock, Wedge/PMI (together with Salomon, their agent and investment adviser) initiated and directed the selling process. Wedge/PMI involved the management of Stewart and Bayley in the selling

Not surprisingly, Section 12(2) claims commonly have been asserted in securities fraud lawsuits against sellers of a company via the private sale of the company's stock. See, *e.g.*, *Astor Chauffeured Limousine Co.* v. *Runnfeldt Inv. Corp.*, 910 F.2d 1540 (7th Cir. 1990); *Devaney* v. *Chester*, 813 F.2d 566 (2d Cir. 1987); *Schaafsma* v. *Morin Vermont Corp.*, 802 F.2d 629 (2d Cir. 1986); *Polycast Technology Corp.* v. *Uniroyal, Inc.*, 728 F. Supp. 926 (S.D.N.Y. 1989). Petitioners have not cited a single case holding that Section 12(2) does not apply to the sale of 100% of the privately-held stock of a company by the owner of the company.[10] Thus, it is hard to imagine a case less requiring this Court's attention.

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process, as owners of an operating company typically do when they decide to sell the operating company, but as the owners Wedge/PMI remained firmly in control. The president of Stewart and Bayley met with representatives of Folger Adam at the direction of the president of PMI, rather than "on an independent basis." And the president of Wedge appropriately regarded the Stewart and Bayley management as "our people." There can be no greater "control" over securities than the control that petitioners exercised here over the sale of their own stock.

[10] Instead, petitioners have string-cited a number of federal district court cases, ostensibly in support of their argument that Section 12(2) does not apply in this case (Pet. at 6-7 n.3), but most of those cases, like *Ballay*, are brokerage cases. Petitioners have also cited a line of cases, even less relevant to the instant case, where purchasers of stock who asserted a claim under Section 12(2) were unable to allege or prove that they purchased their stock *pursuant to* an allegedly misleading prospectus. Those plaintiffs just happened to purchase securities in the secondary market around the same time that the original issuer sold new securities, via allegedly fraudulent offering materials, in an initial public offering. Some courts have held that in such cases, there is an insufficient connection between the stock purchased by the plaintiff and the allegedly fraudulent offering materials to support a claim under Section 12(2). See, *e.g.*, *Ackerman* v. *Clinical Data, Inc.*, [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,207 (S.D.N.Y. July 8, 1985); *Klein* v. *Computer Devices, Inc.*, 591 F. Supp. 270 (S.D.N.Y. 1984); *Gross* v. *Diversified Mortgage Investors*, 431 F. Supp. 1080 (S.D.N.Y. 1977), *aff'd without opinion*, 636 F.2d 1201 (2d Cir. 1980). Such cases are wholly inapposite here, where petitioners made misrepresentations and omissions to respondent in connection

II. THERE IS NO NEED FOR REVIEW OF THE COURT OF APPEALS' FACT-SPECIFIC APPLICATION OF THIS COURT'S SETTLED PRINCIPLES CONCERNING MATERIALITY.

Petitioners contend that this Court should issue the writ in order to "reestablish" the "total mix" test set forth in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976). There is no such need. The District Court, in its unique charge, grossly distorted and misstated the "total mix" test. The Second Circuit corrected that critical error by making manifestly clear that this Court's "total mix" test must be properly stated and applied.

In *TSC*, the Court held that information "is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." 426 U.S. at 449. The Court also offered an alternative formulation: "Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.* More recently, in *Basic Inc.* v. *Levinson*, 485 U.S. 224, 234 (1988), this Court further refined and clarified the definition of materiality: "The role of the materiality requirement is . . . to filter out essentially useless information that a reasonable investor would not consider significant, even as part of a larger 'mix' of factors to consider in making his investment decision."

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with the sale of the stock of Bayley and Stewart, and respondent bought that stock.

Thus, the federal district court cases cited by petitioners do not conflict with the decision of the District Court here that Section 12(2) applies to the private sale of a company's stock by the owner of the company. Of course, even if there were a conflict between the District Court's decision and that of other district courts or even a court of appeals, this Court would not address the conflict at that level. See R. Stern, E. Gressman, and S. Shapiro, *Supreme Court Practice* 207 (6th ed. 1986).

There is, of course, a critical difference under the federal securities laws between materiality and reliance. Information can be material to a buyer without changing the buyer's investment decision. In *TSC*, this Court made the point by stating unequivocally that materiality "does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote." 426 U.S. at 449. As the Second Circuit explained in this case, "No matter how stated . . . it is well-established that a material fact need not be outcome-determinative." Pet. App. at 6a.

Notwithstanding this Court's admonitions, the District Court gave a materiality charge that utterly failed to inform the jury that information could be material without necessarily being outcome-determinative. Even worse, the District Court affirmatively led the jury to believe that for information to be material it must be outcome-determinative, by instructing that information is not material unless it "would have caused [a reasonable investor] to alter its views as to the desirability of proceeding with the purchase." Pet. App. at 5a n.2.

Thus, the District Court's charge transformed the "total mix" test into an outcome-determinative test which flew in the face of *TSC* and *Basic*. At the very least, as the Second Circuit explained, a reasonable juror could have become confused and understood the charge to mean that materiality was necessarily outcome-determinative. Pet. App. at 8a. The strong probability that the jury was misled by the District Court's charge, under the circumstances and on the dispositive issue in the case, required that the judgment be reversed. *Francis* v. *Franklin*, 471 U.S. 307, 325 (1985); *Bollenbach* v. *United States*, 326 U.S. 607, 612 (1946).[11]

[11] In its opinion denying Folger Adam's post-trial motions, the District Court stated that "the mere fact that one might alter one's views as to the desirability of proceeding with a transaction,

Thus, there is no need for this Court to "reestablish" the "total mix" formulation of materiality, since the Second Circuit made clear that it believed the "total mix" formulation is a proper charge on materiality. In this case, the Second Circuit simply reversed the judgment below because the District Court had grossly distorted the "total mix" test in its one-of-a-kind jury instruction. This type of *sui generis* situation does not warrant review by this Court.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

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November 6, 1991

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did not *necessarily* mean that such alteration would ultimately result in a different course of action." Opp. App. at 7a (emphasis added). By stating that the charge did not "necessarily" mean that for information to be material it must "ultimately result in a different course of action" by the buyer, the District Court implicitly recognized that, at the very least, the jury reasonably could have interpreted the charge that way. The District Court did not believe that that possibility warranted a new trial, but as the Second Circuit explained, "the proper inquiry is not whether the jury *necessarily* misconceived the meaning of the materiality charge, but whether, given the ambiguity in the charge, the jury *might* have misunderstood the controlling standard of law." Pet. App. at 8a n.7 (emphasis by court).

APPENDIX

APPENDIX

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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87 Civ. 9272 (WK)

FOLGER ADAM COMPANY,
Plaintiff,
-against-

PMI INDUSTRIES, INC., CONTROL SYSTEMS CORPORATION, WEDGE GROUP, INC. and SALOMON BROTHERS INC,
Defendants.

MEMORANDUM & ORDER

WHITMAN KNAPP, D.J.

Plaintiff Folger Adam Company moves for a judgment notwithstanding the verdict and, in the alternative, for a new trial. For reasons which follow, we deny the motions.

BACKGROUND

In December 1986, plaintiff Folger Adam Company, after an extensive due diligence investigation, purchased from defendants PMI Industries, Inc., Control Systems Corporation, and Wedge Group, Inc. all outstanding stock of Stewart-Decatur Security Systems ("Stewart") and William Bayley Company ("Bayley") (collectively, "the companies"), two companies that, like Folger Adam, were in the detention equipment business. Defendant Salomon Brothers, Inc served as investment banker for the other defendants. A year later in December 1987, finding that the companies' earnings had fallen far short of its expectations, plaintiff filed this suit, alleging that it had been

misled by, among other things, defendants' failure to include certain earnings projections prepared by the companies' operating managers in a selling memorandum and various untrue statements made in that memorandum and during the course of the due diligence investigation.[1]

As demonstrated by the charge and the special verdict questionnaire submitted to the jury, there were two distinct theories of liability upon which plaintiff could have recovered: first, § 12(2),[2] which for a prima facie case required only proof that there had been a material misrepresentation[3] in any oral or written communication made by anyone in connection with the sale and that plaintiff had been unaware that it was a misrepresentation[4] and, second, § 10(b),[5] which required, among other things, proof that a particular defendant, with intent to deceive, had made a material misrepresentation on which plaintiff had justifiably relied.

Plaintiff, however, in its presentation of the case to the jury, made no effort to distinguish between these two theories. On the contrary, throughout the trial, it continually urged that its decision to purchase the companies was fundamentally predicated upon various misrepresentations wilfully made to it (*See, e.g.*, Opening Statement tr. 12-15, 28-32; Summations tr. 3283-86, 3302-03).[6] In

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[1] For a fuller outline of plaintiff's contentions, see our Memorandum & Order of March 29, 1990 denying summary judgment.

[2] Securities Act of 1933, 15 U.S.C. § 77l(2).

[3] Throughout this memorandum, unless otherwise indicated, the term "misrepresentation[s]" encompasses misstatement[s] and omission[s].

[4] We held that the other elements of the § 12(2) claim had been established as a matter of law.

[5] Securities Exchange Act of 1934, 15 U.S.C. § 78j and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder.

[6] Indeed, careful examination of plaintiff's opening statement and both of its summations will not reveal a single word suggesting

support of this contention, Leonard Shaykin and Donald Stading, the key decisionmakers for plaintiff, testified that if the operating managers' projections been disclosed to them, they would not have gone through with the sale (Shaykin tr. 208-09; Stading, tr. 1074) and that they believed and relied upon the higher projections provided in the selling memorandum (Shaykin tr. 167-169, 172) and orally (Shaykin tr. 169, 172, 194-95; Stading tr. 1049-50). Defendants' response to these contentions was that in the particular circumstances of the transaction here involved—where plaintiff was not primarily seeking to purchase the companies for their inherent profitability but for strategic reasons [7] and had had the advantage of an exhaustive due diligence investigation—it would have been inconceivable that a reasonable investor would have deemed important or justifiably relied upon any misrepresentation that defendants might have made.

Both sides called expert witnesses to make their respective positions appear more plausible. Plaintiff called Peter Linneman, a business school professor, who testified that any purchaser would have deemed important and would have justifiably relied upon precisely the kinds of information which defendants in fact withheld from plaintiff. Defendants called Barbara Preiskel who, on the basis of her experience as a director of numerous corporations engaged in similar acquisitions, testified that no reasonable investor seeking to acquire a company for strategic reasons and having had the benefit of a full dress due diligence investigation would have deemed im-

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that the jury could return a verdict for plaintiff without finding reliance by plaintiff and scienter in the defendants.

[7] Defendants maintained that, since Folger Adam sought to purchase the companies to obtain the "strategic" benefits that combining them with Folger Adam would bring—benefits such as reduced competition, joint marketing efforts, shared plants and intracompany sales of certain products—management projections as to what the companies would earn if they were to continue as independent companies were immaterial (*see, e.g.*, Salomon summation tr. 3509-10).

portant or could justifiably have relied upon such information.

On June 28, 1990, after a seven-week trial, the jury returned a verdict for defendants.[8] Plaintiff bases its present motions on claimed deficiencies in the charge and in various evidentiary rulings concerning expert witnesses.[9]

DISCUSSION

I. *The Charge*

Plaintiff asserts that the charge to the jury was inconsistent with the law as declared in *TSC Industries, Inc. v. Northway, Inc.* (1976) 426 U.S. 438. We agree that *TSC* is here controlling[10] but conclude that the charge, as given, was in full conformity therewith.

---

[8] The jury made its finding by answering "no" to the following question:

> Has Folger Adam persuaded you that it is more probable than not that, in connection with the sale of Stewart and Bayley, any written or oral communication was made to Folger Adam which
>
> (a) contained any misstatement(s) of material fact?
>
> or (b) omitted any material fact(s) necessary to prevent such communication, in light of the circumstances under which it was made, from being misleading?

[9] Plaintiff has submitted two memoranda in support of its motions: "Plaintiff Folger Adam Company's Memorandum of Law in Support of Its Motion for a New Trial" and "Plaintiff Folger Adam Company's Memorandum of Law in Support of Its Motion for a Judgment Notwithstanding the Verdict or in the Alternative for a New Trial." The second of these concerns itself with arguments previously advanced in support of motions for partial summary judgment and for a directed verdict. We reject those arguments for the same reasons we previously rejected them. *See* Memorandum & Order, March 29, 1990. This opinion, therefore, will concern itself only with arguments made in the first memorandum.

[10] Plaintiff correctly observed at p. 5 of its memorandum that, during a charging conference, we had questioned whether the adjective "material" should always have the same legal meaning regardless of the nature of the alleged "misrepresentation" it modified. We suggested that the meaning might be different where, as in *TSC*,

It is important to note that one of the Court's principal objectives in *TSC* was to resolve perceived ambiguities in certain language in Justice Harlan's opinion in *Mills v. Electric Auto-Lite Co.* (1970) 396 U.S. 375. In *TSC*, respondent Northway Inc., a stockholder of petitioner TSC, had brought a derivative action for damages growing out of an alleged material omission from a proxy statement pursuant to which TSC had been acquired by another company. The District Court, finding that there remained a genuine issue of fact as to whether or not the omission had been material, had denied a respondent's motion for summary judgment. The Court of Appeals for the Seventh Circuit, in heavy reliance upon *Mills*, had formulated the following definition of materiality: "all facts which a reasonable shareholder *might* consider important." *TSC*, 426 U.S. at 445 (emphasis added by the Supreme Court). Employing that definition, the Court of Appeals had found the omissions to have been material as a matter of law and, reversing the District Court, had directed the entry of partial summary judgment.

The Supreme Court, concluding that the Court of Appeals' reliance upon the *Mills* language had been "misplaced" (*id.* at 446), reversed and reinstated the judgment of the District Court. The Supreme Court adopted the Second Circuit's view as expressed by Judge Friendly that the "might" formulation adopted by the Seventh Circuit was " 'too suggestive of mere possibility, however, unlikely' " (*id.* at 449, *quoting Gerstle v. Gamble-Skogmo, Inc.* (2d Cir. 1973) 478 F.2d 1281, 1302), and established the follow standard:

"material" modified a "misrepresentation" made in a statement addressed to a wide cross-section of persons, many if not most of whom would have had few sources of information other than the statement itself from a situation where, as here, it modified various alleged misrepresentations contained in statements made either in the course of a full scale due diligence investigation or in anticipation of such an investigation. However, as our charge reflects, we discarded that idea before beginning to address the jury.

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . What the standard does contemplate is a showing of substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

TSC at 449.

Adapting the foregoing standard to the facts and arguments before us, we charged as follows:

> In the context of this case, a fact is material when there is a substantial likelihood that, if a reasonable investor had learned of the falsity of the misstatement of fact or the existence of the omitted fact, that investor would have regarded the total mix of information available to have been significantly altered.
>
> By total mix of information, I mean all the information from any source available to such investor at the time it made a decision.
>
> I note that a number of the witnesses were asked whether they would have wanted to know certain information under certain circumstances. An answer to such a question is by no means determinative of whether or not materiality as I defined it has been established. *That certain information would have satisfied the curiosity of any particular investor has nothing to do with the question of materiality unless you find a substantial likelihood that the information supplied in satisfaction of such curiosity would have had, in the view of a reasonable investor, the effect*

> *of significantly altering the total mix of information available and thus would have caused it to alter its views as to the desirability of proceeding with the purchase.*
>
> In other words, information is material when there is a substantial likelihood that a reasonable investor in Folger Adam's circumstances would have regarded the total mix of information available to it—all the information gleaned from the due diligence investigation, publicly available information about the companies and of the detention industry in which they operated—to have been significantly altered, had it discovered that management's views of the companies' prospects were inaccurate or had the lower figures been disclosed.

Tr. 3626-28 (emphasis added in pl. br. at 2-3 n. 1).

Contrary to plaintiff's assertion, the charge did not suggest that plaintiff was required to establish a substantial likelihood that the disclosure would have "resulted in a different decision by the investor." In *TSC*, the mere fact that a shareholder would consider certain information important "in deciding to vote" did not necessarily mean that consideration of such information would ultimately change his decision. So here, the mere fact that one might alter one's views as to the desirability of proceeding with a transaction, did not necessarily mean that such alteration would ultimately result in a different course of action. In either situation, the requirement is simply that the omitted matter be sufficiently significant to cause the shareholder or investor to give thought to the problem with which he was faced; *i.e.*, that it "would have assumed actual significance in [his] deliberations." *Id.*, 426 U.S. at 449.

II. *The Evidentiary Rulings*

Plaintiff's claims of evidentiary error center on the testimony of its own expert witness, Linneman, and on

that of defendants' expert, Preiskel. Plaintiff contends that Linneman was unduly restricted and that Preiskel was not properly qualified to express the opinions to which she testified. Neither contention has merit.

As plaintiff correctly points out, before Linneman took the stand, we ruled that he could not "refer to any particular document or any particular piece of information" (tr. 1355) or give his opinion as to whether "Salomon Brothers did or didn't do certain things and whether Salomon should or shouldn't have done certain things" (tr. 1425). According to plaintiff's brief, these rulings undermined its "expectation" that Linneman would, in the course of his testimony, be permitted to testify that operating managers' views of their companies' prospects are "important" to investors; to assess the importance of those views in the context of this case; to examine specific documents and testimony concerning the sale; to testify "regarding specific events involved in the sale"; and to express his opinion on some of the "ultimate" factual issues in the case (pl. br. at 12).

An examination of the transcript reveals that, whatever ~~may~~ have been the intent of our initial rulings, Linneman was not precluded from giving testimony with respect to any of the foregoing matters. First of all, Linneman testified repeatedly that he believed that the operating managers' projections were "important" to investors. For example, plaintiff's counsel elicited this testimony:

> Q. Dr. Linneman, whose projections in your opinion are most important to potential buyers?
>
> A. Clearly you want to have those management, operating management projection[s].
>
> Q. When you say operating management who do you mean by operating management?
>
> A. The people, whoever they are, who are at the company day to day making the decisions about what

> that company does, which employees are there, who gets hired to replace the employees that leave, where you buy your steel from, where you get—those kind of decisions that matter. Those are the people who know the company. That's why their views are invaluable (tr. 1454-55).

See also tr. 1439-44, 1451-52, 1461-63, 1471-72, 1474-79, 1482-83. He went on to testify that "management projections always matter, in my opinion at least" (tr. 1476) and that a buyer would "always want" them (tr. 1477). With plaintiff's counsel's prompting, Linneman even named the men who, in his view, were the operating managers of the companies (tr. 1468-71).

Having established that Linneman thought that projections prepared by operating managers were important and that specific persons at the companies were those operating managers, plaintiff's counsel asked a hypothetical question tailored to the specific facts in this case.[11] Linneman was asked to assume that Folger Adam was considering acquiring Stewart and Bayley in 1986; that the combined operating income was $2.3 million in 1984, $4 million in 1985 and $4.8 million in 1986; that Folger Adam repeatedly asked the seller and Salomon for operating managers' projections; that Folger Adam was given projections that predicted $4 million for 1987; that Folger Adam was told that the $4 million figure was the operating managers' projection, but that in the seller's estimation the number really should be higher; that the seller and Salomon knew that, in the spring of 1986, the operating managers had been asked to provide projections and did provide projections of $2.9 million for 1987, $2.3 million for 1988 and $2.5 million for 1989; that, in October 1986, in response to repeated requests for management projections, the operating managers predicted that

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[11] Before commencing that line, plaintiff's counsel sought and received our ruling that hypothetical questions were permissible (tr. 1463-66).

the operating income for 1987 would be $2.4 million; and that defendants did not disclose those lower numbers to Folger Adam (tr. 1485-87). In response, Linneman testified over defendants' objection (tr. 1487) that, had the lower numbers been revealed, they would have altered the perceived risks and dramatically changed plaintiff's analysis (tr. 1488-92). Summing up, plaintiff's counsel asked Linneman if he had an opinion as to whether or not "our hypothetical Folger Adam or any other reasonable buyer would want to know" the operating managers' lower projections. Linneman, not surprisingly, responded "yes" (tr. 1492).

Finally, turning his attention to Salomon, plaintiff's counsel posed another fact-specific hypothetical question. He asked Linneman further to assume that Salomon knew that the operating managers had projected $2.9 million for 1987, $2.3 million for 1988 and $2.5 million for 1989; that Salomon attended a meeting on October 14, 1986 at which plaintiff asked for management projections; that at that meeting Folger was told that the projections were $4 million; that plaintiff was also told that those projections were conservative and that the number was really higher, closer to $5 million; and that Salomon, although aware of the lower numbers, did not disclose them (tr. 1492-93). Linneman gave his unequivocal opinion that Salomon's failure to disclose the existence of the lower numbers was not "consistent with what would be expected of a reputable investment banker" (tr. 1494). He elaborated:

> This is the type of information. Management on the site, their opinions about the future, the type of such that a sophisticated investment banker like Salomon knows is important. Knows is part of determining what buyers are willing to pay and which buyers are interested. They would have to sometime, somehow, some way to make sure that that information is fully and fairly disclosed before the transaction is con-

> cluded, fulfilling their role as an honest broker doing the normal things that an investment banker does (tr. 1494).

Without seeking to direct Linneman's attention to any other area, plaintiff's counsel thereupon ended the direct examination.

Although plaintiff does not point in its brief to any specific document, testimony or event about which it was precluded from eliciting testimony, it is clear that it was permitted to—and did—put virtually every one of its principal factual contentions before Linneman in the form of hypothetical questions. There is therefore no basis for the assertion that our rulings foreclosed eliciting Linneman's testimony as to "whether and why the particular misstatements and omissions would have been important to a reasonable investor, and whether Salomon Brothers acted contrary to investment banking standards by participating in those misstatements and omissions" (pl. br. at 19). As the above-summarized testimony illustrates, Linneman was permitted to do nothing less than express his opinion as to each of what, at least from plaintiff's point of view, were the "ultimate" issues in the case.

Similarly unfounded is plaintiff's assertion that Barbara Preiskel, who has served as a director of several major corporations and has been called upon to make investment decisions about numerous acquisitions and divestitures including at least fifteen strategic acquisitions, was not qualified to give the testimony that she did.

Preiskel defined a strategic acquisition as one designed "to enhance the business that you are in . . . , to either improve your product line, if it is a related product, or your market share or something which will improve the business that you are now conducting and you think you can improve it by acquiring another company which is related to it" (tr. 2648). She testified that, in making

such investment decisions, she never reviewed a selling memorandum prepared by a seller's investment banker, never asked to see one, and did not recall any of her fellow directors' having asked to see one (tr. 2659-61). She also testified that she had only once received projections which she understood to have been prepared by the management of the target company, never asked to see any, and did not recall her fellow directors ever having asked to see any (tr. 2661-64).

In response to hypothetical questions similar in structure to those that had been asked of Linneman by plaintiff's counsel, she gave her opinion that, in making an investment decision as to whether or not to make a strategic acquisition of companies such as Stewart and Bayley, she would not consider it important to know what the target companies' managers projected the companies' future sales and operating income would be as separately operated concerns (tr. 2666-71); that a reasonable investor who owned a company in a related business and who had an opportunity to conduct a due diligence investigation would not consider such projections important (tr. 2672); and that an investor who relied on such projections in such a situation would not be acting reasonably (tr. 2672-73). She explained that the situation would be different in the case of management leveraged buyout where the acquired company would continue to operate independently (tr. 2704).

She went on to testify that, in making a strategic investment decision, she would not consider it important to see a selling memorandum prepared by the seller's investment banker (tr. 2673-74); that, in her opinion, a reasonable investor who owned a company in a related business and had an opportunity to conduct a due diligence investigation would not consider that memorandum important (tr. 2674-75); and that any such investor who relied on such a memorandum would not be acting reasonably (tr. 2675-76).

Since, as above noted, her testimony was directed at plaintiff's principal contention (which had, in explicit detail, been supported by Linneman's testimony) that persons in the position of Shaykin and Stading, *i.e.*, the ultimate decisionmakers, would reasonably have relied on the statements that were claimed to have been made, it is inconsequential that—as was made clear on direct examination (tr. 2641, 2665) and then emphasized at length during plaintiff's counsel's cross examination (tr. 2684-88, 2691-93, 2696-97)—Preiskel herself did not conduct due diligence investigations, did not know what her companies' managers considered when they prepared their own projections for combined companies and did not know whether they reviewed target company management projections as part of that process.

CONCLUSION

As stated in footnote 9 on page 4, the deny the motion for a judgment notwithstanding the verdict for reasons heretofore expressed. Finding no merit in plaintiff's motion for a new trial, we likewise deny that motion.

SO ORDERED.

New York, New York
August 1, 1990

WHITMAN KNAPP, U.S.D.J.

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(3)

No. 91-570

IN THE

Supreme Court of the United States

October Term, 1991

PMI INDUSTRIES, INC., CONTROL SYSTEMS CORPORATION, WEDGE GROUP, INC. AND SALOMON BROTHERS INC,

Petitioners,

v.

FOLGER ADAM COMPANY,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

REPLY BRIEF FOR PETITIONERS

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IN THE

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FOLGER ADAM COMPANY,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

REPLY BRIEF FOR PETITIONERS

Petitioners PMI Industries, Inc. ("PMI"), Control Systems Corporation ("CSC"), WEDGE Group, Inc. ("WEDGE") and Salomon Brothers Inc ("Salomon"), defendants-appellees below, respectfully submit this reply brief in further support of their petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit.

BACKGROUND OF THE CASE

Plaintiff Folger Adam Company's ("Folger Adam") claims arose out of its purchase from PMI of the stock of two subsidiaries, Stewart-Decatur Security Systems, Inc. ("Stewart") and The William Bayley Company ("Bayley"). Folger Adam alleged violations of Section 12(2) of the Securities Act of 1933 (the "Securities Act"), 15 U.S.C.

§ 771(2), Section 10(b) of the Securities Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j(b), Securities and Exchange Commission Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, and the common law.

The dispositive issue presented to the jury was whether (a) certain projections furnished to Folger Adam were "materially" misleading, and (b) omitted and admittedly hastily-drawn projections by managers of Stewart and Bayley who had a history of "serv[ing] up numbers that were to easy to hit" and who were interested in purchasing the companies themselves, were "material." After hearing seven weeks of evidence concerning the nature of the projections given and omitted and the wealth of information uncovered by Folger Adam in the due diligence process, the jury found no material misrepresentation or omission, and returned a verdict for defendants. The United States District Court for the Southern District of New York (Knapp, J.) entered judgment in accordance with the verdict.

The Court of Appeals reversed the judgment on the grounds that the jury "may have" been confused in its deliberation because the District Court instructed (a) that information is "material" if it would significantly alter the "total mix" of information made available, without also explicitly stating that such information need not change the reasonable investor's decision, and (b) that "alter the 'total mix'" means "alter [one's] views as to the desirability of proceeding with the transaction."

ARGUMENT

THE COURT OF APPEALS' DECISION IS PLAINLY ERRONEOUS AND OF PROFOUND SIGNIFICANCE AND SHOULD BE SUMMARILY REVERSED

Petitioners urge the Court to, *inter alia*, summarily reverse this decision by the Court of Appeals because it is plainly erroneous and will profoundly affect the use of this Court's "alter the 'total mix'" test for determining materiality under federal securities laws. Pet. at

15-21.[1] Contrary to the Court of Appeals' decision, neither *"altering the 'total mix'"* nor *"altering views as to the desirability of proceeding* with the transaction" necessitates or even suggests a *changing of the vote to proceed*, and the reversal by the Court of Appeals of a seven-week trial that concluded with a verbatim rendition of this Court's "total mix" test—and the instruction to add to its charge a completely different formulation for materiality on remand—already has begun to eviscerate the test.

In their opposing brief, Respondent has avoided a direct response to these arguments and instead has characterized the Court of Appeals' decision as simply a correction of a distorted and misstated rendition of the "total mix" test. Res. at 16-18. As demonstrated below, however, the test was set forth by the District Court exactly as prescribed by this Court, and Respondent's opposition has served only to highlight the appellate court's misunderstanding of the test and the clear need for summary reversal of its decision.

A. The Court of Appeals' Decision is Plainly Erroneous

Respondent has characterized the Court of Appeals' decision as merely a rejection of a "unique" charge that "grossly distorted and misstated the 'total mix' test." Res. at 16. That is absolutely incorrect. This Court's statement of the "total mix" test is as follows:

> there must be a *substantial likelihood* that the *disclosure of the omitted fact* would have been viewed by the *reasonable investor* as having *significantly altered the "total mix" of the information made available.*

TSC Industries, Inc. v. *Northway, Inc.*, 426 U.S. 438, 449 (1976) (emphasis added) (footnote omitted). The District Court charged the jury precisely in accordance with that precedent:

> In the context of this case a fact is material when there is a *substantial likelihood* that, if a *reasonable investor* had learned of

[1] References to the Petition or to an appendix thereto are cited as "Pet. at ____" or "Pet. App. at ____," respectively. References to the Respondent's Opposition or to the Appendix thereto are cited as "Res. at ___" or "Res. App. at ___," respectively.

> the falsity of the misstatement of fact or the ***existence of the omitted fact,*** that investor would have regarded ***the total mix of information available to have been significantly altered.***

Pet. App. at 5a n.2 (emphasis added). In fact, the Court of Appeals rejected a verbatim rendition of this Court's "total mix" test because it simply misunderstood the test.

(i) The Court of Appeals Completely Misunderstood this Court's "Total Mix" Test as Outcome-Determinative

The primary basis of the Court of Appeals' decision is that this verbatim rendition of this Court's "total mix" test is inappropriate, without further explanation, because it is "outcome-determinative":

> we think that the jury would take the "total mix" formulation to mean that a material fact is one that would cause a reasonable investor to change her decision on whether to consummate a transaction.

Pet. App. at 7a.

The Court of Appeals' understanding of the "total mix" test is simply incorrect. There is absolutely no equivalence between "alter[ing] the 'total mix' of information made available" and changing the ultimate decision on whether to consummate the transaction. In any event, altering the "total mix" suggests a *change in decision* no more than *TSC v. Northway*'s "consider important in deciding how to vote" test, its "significant propensity to affect the voting process" test, or its "important enough to assume actual significance in the deliberations of the reasonable shareholder" test, the use of which the Court of Appeals instructed on remand. Pet. App. at 10a. It is not surprising that Respondent has been unable to point in its opposition to a single instance in which any other court has rejected the "total mix" language because it "may" be construed as outcome-determinative, held that an instruction based on it is erroneous unless embellished, or suggested that it is different from any of the alternative formulations of the materiality definition in *TSC v. Northway*.

(ii) The Court of Appeals Completely Misunderstood the District Court's "Alter Views as to the Desirability" Explanation of the "Total Mix" Test as Outcome-Determinative

In an effort to explain the "total mix" concept to the jury, the District Court charged further that "significantly altering the total mix of information available" means that the omitted information "would have caused [the reasonable investor] to *alter its views as to the desirability of proceeding* with the purchase." Pet. App. at 5a n.2 (emphasis added). In reversing, the Court of Appeals ruled that, like this Court's "total mix" test, this explanation also "may have" led the jury to believe it was required to find that the investor actually *changed its decision* because of the alleged misstatement—*i.e.*, that the "alter views as to the desirability" language is also outcome-determinative.[2] This ruling is incorrect on its face and demonstrates an even more profound misunderstanding by the Court of Appeals of the District Court's charge and of the concept of outcome-determinativeness.

Clearly, the word "alter" in this portion of the District Court's charge modified only "views as to the desirability," and "altering views as to the desirability" does not mean "altering the decision." The desirability of proceeding may be increased so as to confirm a decision to proceed, or it may be decreased, but not so much as to cause a change in plans. "[A]lter[ing one's] views as to the desirability of proceeding," is simply not the equivalent of "changing one's mind about whether to proceed." Indeed, under the *TSC v. Northway* test, a "material" fact would necessarily alter, at least to some degree, one's view as to the desirability of proceeding with the transaction, for a fact could not be "consider[ed] important in deciding how to vote," "have a significant propensity to affect the voting process," "assume[] actual significance in the deliberations of the reasonable shareholder," or be

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[2] Despite Respondent's suggestions to the contrary, the Court's decision was not a rejection only of the District Court's "alter views as to the desirability" language. Indeed, the Court stated unequivocally that the *TSC v. Northway* formulation of the "total mix" test was outcome-determinative and that this language merely "compounded" the "misleading" charge on the "total mix" test. Pet. App. at 7a.

substantially likely to be "viewed by the reasonable investor as having significantly altered the 'total mix' of information available" and not also "cause[] [the reasonable investor] to alter its view as to the desirability of proceeding with the purchase."

B. The Court of Appeals' Decision Has Eviscerated This Court's "Total Mix" Test

We respectfully submit that the very fact that the United States Court of Appeals for the Second Circuit found the District Court's verbatim rendition of the "total mix" test to be, as Respondent suggests, a "grossly distorted and misstated view of the 'total mix' test" is precisely the reason that this Court should summarily reverse the decision below. Such an appellate ruling can only have the effect of eviscerating this Court's "total mix" test. District judges and litigants will not, and as a practical matter should not, utilize the "total mix" test in the wake of such a dramatic result. *See, e.g., Katz v. Pels*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,125 at 90,698 n.4 (S.D.N.Y. July 22, 1991).

C. This Court Should Summarily Reverse the Court of Appeals' Decision

The Court of Appeals' rejection of the "total mix" test is in direct conflict with this Court's established precedent. Because the charge was based directly on this Court's authority, the Court of Appeals' reversal was necessarily wrong. This Court should reverse to avoid the needless retrying of a seven-week trial in a mundane commercial dispute. Of greater significance, a swift reversal by this Court will restore its "total mix" test for all litigants. We respectfully urge this Court to exercise its powers of summary reversal.

CONCLUSION

For the foregoing reasons, the Petition should be granted and this Court should summarily reverse the Court of Appeals' decision.

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Respectfully submitted,

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